CLERK'S COPY.

TRANSCRIPT OF RECORD

Supreme Court of the United States

OCTOBER TERM, 1945

No. 47

TALBOT MILLS, PETITIONER,

vs.

COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIRST CIRCUIT

PETITION FOR CERTIORARI FILED MARCH 22, 1945.

CERTIORARI GRANTED APRIL 30, 1945.

UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIRST CIRCUIT.

OCTOBER TERM, 1943.

No. 4015.

TALBOT MILLS,

PETITIONER FOR REVIEW,

v.

COMMISSIONER OF INTERNAL REVENUE.

PETITION FOR REVIEW OF DECISION OF THE TAX COURT OF THE UNITED STATES.
DECISION, FEBRUARY 12, 1944.

RECORD ON PETITION FOR REVIEW.

MELVILLE F. WESTON,
POWERS & HALL,
for Petitioner.

SAMUEL O. CLARK, JR.,
ASSISTANT ATTORNEY GENERAL,
SEWALL KEY,
SPECIAL ASSISTANT TO THE ATTORNEY GENERAL,
for Commissioner of Internal Revenue.

BOSTON:
PRINTED UNDER DIRECTION OF THE CLERK
1944

TABLE OF CONTENTS.

	Page
Court (Circuit Court of Appeals) and Title of Case	1
Record on Petition for Review:	
Docket Entries, Tax Court of the United States	1
Excerpts from Petition	3
Excerpts from Amended Answer	7
Stipulation of Facts	8
Exhibits:	
3-C, — Plan of Reorganization dated Sept. 14, 1939	18
4-D, — Form of Registered Note due Dec. 1, 1964	19
5-E, — Articles of Amendment	26
6-F, — Excerpts from Agreement, Oct. 10, 1939	29
7-G, — Minutes of Stockholders' Meeting, Sept. 29, 1939	36
8-H, — Minutes of Directors' Meeting (excerpts), May 8, 1939	39
9-I, — Same, Sept. 14, 1939	40
10-J, — Same, Sept. 29, 1939	41
11-K, — Same, Oct. 10, 1939	43
12-L, — Same, Nov. 27, 1939	45
13-M, — Same, Sept. 17, 1940	48
14-N, — Same, Nov. 27, 1940	48
15-O, — Same, March 28, 1941	49
16-P, — Same, Sept. 15, 1941	51
17-Q, — Same, Nov. 24, 1941	52
Petitioner's Exhibit 1-A, —Tax return for 1939	55
2-B, — Notice of Deficiency	57
Proceedings before the Tax Court (excerpts)	59
Findings of Fact and Opinion	73

PAGE

Computation for Entry of Decision 81
Decision 85
Petition for Review 86
Notice of filing Petition for Review 87
Designation of Contents of Record 88
Amendment to Designation 89
Certificate of the Tax Court 90
Enlargement of time for docketing case 90
Statement of Points 90

Proceedings in U. S. C. C. A., First Circuit . . . 93
Minute entry of hearing 93
Opinion, Mahoney, J. 93
Dissenting opinion, Magruder, J. 100
Final decree 104
Recital re issuance of mandate 104
Order allowing certiorari 104

UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIRST CIRCUIT.

OCTOBER TERM, 1943.

No. 4015.

TALBOT MILLS,
PETITIONER FOR REVIEW,
v.
COMMISSIONER OF INTERNAL REVENUE.

RECORD ON PETITION FOR REVIEW.

[FILED IN CIRCUIT COURT OF APPEALS JUNE 27, 1944.]

Docket No. 1066

TALBOT MILLS, Petitioner,
v.
COMMISSIONER OF INTERNAL REVENUE, Respondent.

APPEARANCES.

For Taxpayer:
MELVILLE F. WESTON, Esq.

For Commissioner:
M. L. SEARS, Esq.

DOCKET ENTRIES.

1943
Mar. 24 – Petition received and filed. Taxpayer notified. Fee paid.
Mar. 25 – Copy of petition served on General Counsel.
Apr. 24 – Answer filed by General Counsel.
Apr. 24 – Request for hearing in Boston, Massachusetts filed by General Counsel.
Apr. 27 – Notice issued, placing proceeding on Boston, Mass. calendar. Service of answer and request made.

July 29 – Hearing set Sept. 20, 194 , Boston, Mass.
Aug. 18 – Motion for leave to file amended answer, amended answer lodged, filed by General Counsel. 8-19-43. Granted.
Sept. 6 – Notice of appearance of Melville F. Weston as counsel filed.
Sept. 21 – Hearing had before Judge Arundell on the merits. Submitted. Stipulation of facts filed. Briefs as per Rules —Nov. 5, 1943. Nov. 20, 1943.
Oct. 4 – Transcript of hearing 9-21-43 filed.
Nov. 3 – Brief filed by General Counsel. Served 11-4-43.
Nov. 4 – Brief filed by taxpayer. 11-4-43 Copy served on General Counsel.
Nov. 13 – Notice of intention not to file reply brief filed by General Counsel.
Nov. 15 – Reply brief filed by taxpayer. 11-15-43 Copy served on General Counsel.

1944

Jan. 21 – Findings of fact and opinion rendered, Arundell, Judge, Div. 7. Decision will be entered under Rule 50. 1-21-44 Copy served.
Feb. 9 – Computation of deficiency filed by General Counsel. Agreed to.
Feb. 11 – Decision entered, Arundell, Judge, Div. 7.
May 2 – Petition for review by U. S. Circuit Court of Appeals, 1st Circuit, filed by taxpayer.
May 2 – Designation of contents of record filed by taxpayer.
May 3 – Notice of filing petition for review sent to J. P. Wenchel filed.
May 4 – Proof of service filed.
May 17 – Amendment to designation of record filed by taxpayer.
May 24 – Proof of service of designation of contents of record and amendment to designation of record filed by taxpayer.

June 8 – Stipulation with respect to corrections in stenographic transcript filed.

June 10 – Order granting time to 7-31-44 to prepare and transmit the record entered.

[Title omitted.]

(EXCERPTS FROM) PETITION.

[Filed March 24, 1943.]

The above-named petitioner hereby petitions for a redetermination of the deficiency set forth by the Commissioner of Internal Revenue in his notice of deficiency, Bureau Symbols TMK:HWL:WJM:c, dated January 7, 1943, and as a basis of its proceeding alleges as follows:

1. The petitioner is a Massachusetts corporation with a principal office at Faulkner Street, North Billerica, Massachusetts. The return for the period here involved was filed with the Collector for the District of Massachusetts.

2. The notice of deficiency, a copy whereof is attached hereto marked Exhibit A, was mailed to the petitioner on January 7, 1943. Reference is made in this notice to "the report of examination dated November 4, 1941" and there is therefore attached hereto, marked Exhibit A-1, a series of excerpts from that report of examination, being those parts material to the issues set out in the assignments of errors below (and which may be thought necessary to "elucidate" the determination.)

3. The taxes in controversy are income and declared value excess profits taxes for the fiscal year ended September 30, 1940, and in the amount of $9,177. (The total deficiency amounts to $9,784.81, but certain minor adjustments are not contested.)

4. The determination of the tax set forth in the said notice of deficiency (to the extent of the said sum of $9,177, or such other sum as may be properly computed in the premises) is based upon the following errors:

1. The determination that "(d) Interest on stockholders notes 40,000.00" constituted an "unallowable deduction" under the Internal Revenue Code.—See Exhibit A. pp. 1, 3.

2. The determination that the said amount of $40,000, deducted as interest in the 1940 income and excess profits tax return, did not represent interest within the meaning of Section 23(b) of the Internal Revenue Code.—See Exhibit A, p. 3.

No errors are assigned here to the contents of Exhibit A-1, though much of the same appears erroneous, as the deficiency notice merely shows the same to have been "considered", not, apparently, adopted.

5. The facts upon which the petitioner relies as the basis of these proceedings are as follows:

(*a*) On October 2, 1939, the petitioner made an exchange with its stockholders whereby the petitioner issued an aggregate amount of $400,000 of registered notes dated October 2, 1939, in exchange for 4,000 shares out of the 5,000 outstanding shares of the petitioner's $100 par value capital stock. This exchange was made pursuant to the vote of the petitioner's stockholders taken at a stockholders' meeting held September 29, 1939, at which a plan of reorganization embodying the said exchange was approved and adopted, and the carrying out of the same was authorized and directed, all such action being the unanimous action of all the stockholders.

(*b*) On September 29, 1939, the stockholders also voted unanimously to reduce the capital stock of the corporation from $500,000, consisting of 5,000 shares of $100 par value, to $100,000, consisting of 1,000 shares of $100 par value, such reduction to be effected by the cancelling and retiring of the 4,000 shares to be acquired upon the above exchange. On October 10, 1939, the Articles of Amendment embodying this reduction of capital, as required by the laws of the Com-

monwealth of Massachusetts, were duly filed and the same were thereafter duly approved by the Commissioner of Corporations and Taxation.

(*c*) A copy of the form of registered note issued under date of October 2, 1939, as above, is annexed hereto marked Exhibit B. By inadvertence the petitioner was therein described as "Talbot Mills, Inc.", where as in fact the corporate name of the petitioner is "Talbot Mills". But this is the form which has actually been used for the issuance of all the notes and the "Talbot Mills, Inc." therein referred to is in fact the petitioner corporation and none other.

(*d*) In the fiscal year ended September 30, 1940, the net earnings of the petitioner, computed in accordance with the regular bookkeeping methods and practices of the petitioner, as established from time to time in good faith by its directors and officers, amounted, without deduction for federal income taxes paid or accrued and without deduction for interest upon the notes, to an aggregate sum two-thirds whereof equalled a sum largely in excess of $40,000. As a result thereof the rate of interest upon said notes for said fiscal year ended September 30, 1940, was duly determined, in accordance with the terms of the said notes, to be at the rate of 10 per cent for the said fiscal year.

(*e*) During the entire fiscal year ended September 30, 1940, there were at all times outstanding an aggregate amount of $400,000 of said notes. The total amount of interest payable upon said notes at the above rate for and on account of the said fiscal year was, therefore, $40,000. The petitioner kept and keeps its books and made and makes its returns upon an accrual basis and it therefore accrued upon its books for the fiscal year ended September 30, 1940, and deducted in its 1940 income and declared value excess profits tax return, the said sum of $40,000 as interest upon said notes for said fiscal year.

(*f*) Said exchange described in sub-paragraph (a) above was actual and bona fide and said notes were issued for a

genuine, full and adequate consideration and during the fiscal year in question and at all times subsequent have remained outstanding as the valid and enforceable interest-bearing money obligations of the petitioner. The said sum of $40,000 accrued upon the petitioner's books for and on account of the said fiscal year and deducted in its return for said year constituted in fact and in law interest for said year upon its said obligations.

Wherefore the petitioner prays that this court may hear the proceedings and set aside the Commissioner's said determination and redetermine the said deficiency in such sum, if any, as may remain after due allowance, in the computation of the petitioner's net income for the said fiscal year, of said sum of $40,000 as a deduction for interest accrued within said year upon indebtedness of the petitioner.

TALBOT MILLS,
by THOMAS TALBOT CLARK,
President and Treasurer.
Faulkner Street, North Billerica, Massachusetts

COMMONWEALTH OF MASSACHUSETTS.
MIDDLESEX, ss.

Thomas Talbot Clark, being duly sworn, says that he is the president and treasurer of the above-named petitioner Talbot Mills, and as such duly authorized to verify the foregoing petition; that he has read the foregoing petition, or had the same read to him, and is familiar with the statements contained therein and that the statements contained therein are true.

THOMAS TALBOT CLARK.

Subscribed and sworn to before me this twenty-second day of March, 1943.

RICHARD H. LANIGAN,
Notary Public.

My Commission Expires February 9, 1945.

* * * * * *

[Title omitted.]

(EXCERPTS FROM) AMENDED ANSWER.

[Filed August 18, 1943.]

Comes now the Commissioner of Internal Revenue, by his attorney, J. P. Wenchel, Chief Counsel, Bureau of Internal Revenue, and for amended answer to the petition filed in this proceeding, admits, denies and alleges as follows:

1. Admits the allegations contained in paragraph 1 of the petition.

2. Admits that the notice of deficiency, a copy of which is attached to the petition and marked Exhibit A, was mailed to the petitioner on January 7, 1943. Denies the remaining allegations contained in paragraph 2 of the petition.

3. Admits the taxes in controversy are income and declared value excess-profits taxes for the fiscal year ended September 30, 1940 and that certain adjustments are not contested. Denies the remaining allegations contained in paragraph 3 of the petition.

4. 1 and 2. Denies the assignments of error contained in paragraph 4, 1 and 2 of the petition.

5. (*a*) to (*d*), inclusive. Denies the allegations of fact and conclusions of law contained in paragraph 5 (*a*) to (*d*), inclusive, of the petition.

(*e*) Admits the petitioner deducted in its 1940 income and declared value excess-profits tax return the sum of $40,000 as interest. Denies all other matter contained in paragraph 5 (*e*) of the petition.

(*f*) Denies the allegations of fact and conclusions of law contained in paragraph 5 (*f*) of the petition.

Denies generally and specifically each and every allegation contained in the petition, not hereinbefore admitted, qualified, or denied.

6. For further answer, respondent alleges that as a result of a mathematical error, the deficiency asserted in the notice of deficiency should have been for income tax in the amount of $7,546.96

and declared value excess-profits tax in the amount of $2,415.73, or a total amount of $9,962.69.

7. In support of the foregoing allegation the respondent relies on the following facts:

a. In the computation contained in the statement annexed to the deficiency letter the respondent failed to assert the defense tax with respect to declared value excess-profits tax in accordance with Section 204(b) of the Revenue Act of 1940.

b. The proper computation is as shown in the annexed revised audit statement annexed hereto and made a part hereof.

c. By correcting the said mathematical error above referred to, the deficiency in income tax is reduced by $41.73 and the deficiency in declared value excess-profits tax is increased by $219.61 for which latter amount the respondent asserts a claim.

Wherefore, it is prayed that the appeal be denied and that the deficiency be found in the increased amount herein claimed.

J. P. WENCHEL, CPR,
Chief Counsel, Bureau of Internal Revenue.

Of Counsel:

CHARLES P. REILLY,
Division Counsel.

MELVIN L. SEARS,
Special Attorney, Bureau of Internal Revenue.

[Title omitted.]

STIPULATION OF FACTS.

[Filed September 21, 1943.]

It is hereby stipulated and agreed by and between the petitioner, by its attorney, and the respondent, by his attorney, that the following are facts, and that this stipulation may be received on the trial of this proceeding, subject to the right of either party to object to the admission in evidence of any statement herein con-

tained on the ground that the same is irrelevant or immaterial, and subject also to the right of either party to introduce additional evidence not inconsistent herewith:

I. The petitioner herein, Talbot Mills, is a Massachusetts corporation, with a principal office at Faulkner Street, North Billerica, Massachusetts.

The petitioner filed its income and declared value excess profits tax return for its fiscal year ended September 30, 1940, in the office of the Collector of Internal Revenue for the District of Massachusetts at Boston, Massachusetts, on December 14, 1940. Said return showed a net income of $156,328.27, an income tax of $29,702.37, and no amount of declared value excess profits tax. A photostatic copy of said return may be introduced in evidence as Exhibit 1-A without objection.

It is agreed by the parties hereto that no inference shall be attached to the use in this stipulation of words of legal conclusion in description of the transaction herein involved. For example, but without limitation of the reservation to the words employed in the example, the use in this stipulation of the words "plan of reorganization", "interest" or "notes" does not by itself give rise to any inference that the transaction was pursuant to a plan of reorganization or was a reorganization or that the transaction produced an amount properly denoted as interest or that the instruments issued were notes within the meaning of such terms as used in, or properly used in the lawful application of, the Internal Revenue Code. For purposes of convenience the terminology employed by the petitioner is accepted but such terminology shall not in any way preclude respondent from arguing the non-deductibility as interest of the amount of $40,000 which is the subject of this proceeding. This reservation is in no wise intended to bar the drawing of all proper inferences from the facts themselves.

II. In its said return for the fiscal year ending September 30, 1940, in setting forth and computing its net income, the petitioner deducted the sum of $40,000 accrued as "interest". The said sum of $40,000 was paid as follows: $10,000—December 2, 1940;

$10,000—March 27, 1941; $20,000—September 15, 1941. The payments were made by the petitioner pursuant to the terms and provisions relating to "interest" of certain "notes" hereinafter described.

The petitioner kept and keeps its books and made and makes its returns upon an accrual basis.

III. On January 7, 1943, the Commissioner of Internal Revenue transmitted to the petitioner by registered mail a deficiency notice, a copy whereof may be introduced in evidence as Exhibit 2-B without objection.

IV. In said notice of deficiency the said deduction of $40,000 as "interest" was disallowed. Certain minor adjustments, not connected with said $40,000 deduction, were also made by the respondent and are not contested by the petitioner. The total deficiency determined by the respondent was in the sum of $9,784.81, whereof $7,588.69 was income tax and $2,196.12 was declared value excess profits tax. By amended answer the respondent now claims an increased deficiency based on a mathematical error in the deficiency notice. The deficiency now asserted is $9,962.69, of which $7,546.96 is income tax and $2,415.73 is declared value excess profits tax. Of these amounts $6,940.15 of income tax and all of the declared value excess profits tax is in controversy. The portion of the controversy, namely, $606.81, has, with the consent of the petitioner, been assessed and paid.

V. Prior to the commencement of the petitioner's fiscal year ending September 30, 1940, the petitioner had outstanding as its total capital stock 5,000 shares of (common) capital stock with a par value of $100 per share, or an aggregate capital stock of $500,000. It had a surplus appearing upon its books in the sum of $472,754.18, and the value of its said outstanding stock was not less than $100 per share at the time of the exchange hereinafter described. The stock was held on September 30, 1939, by fifteen stockholders who (with the exception of one holder of 10 shares to qualify as a director) were all members of the Talbot family by descent or marriage or were trusts created by such members.

VI. On September 14, 1939, there was submitted, at a meeting, duly held, of the Board of Directors of the petitioner a "plan of reorganization", a copy whereof is hereunto annexed, marked Exhibit 3-C. Annexed to said plan was a draft of a form of "Registered Note due December 1, 1964", which form was identical with the form of "note" finally adopted, a copy of which is annexed hereto marked Exhibit 4-D. At said directors' meeting, it was—

"VOTED: That the plan of reorganization and form of note annexed hereto be adopted and approved and that its adoption be recommended to the stockholders."

See further Exhibit 9-I annexed hereto.

VII. At a special meeting, duly held, of the stockholders of the petitioner on September 29, 1939, it was unanimously—

"VOTED: To approve and adopt the said Plan of Reorganization."

See further Exhibit 7-G annexed hereto.

VIII. At a meeting, duly held, of the Board of Directors of the petitioner, on September 29, 1939, following the stockholders' meeting above referred to, the unanimous action of the stockholders was reported and votes were passed in furtherance of said "plan", of the issuance and authentication of the "registered notes" of the petitioner, and of the exchange contemplated by the "plan" set forth in Exhibit 3-C annexed hereto. See further Exhibit 10-J annexed hereto.

IX. Pursuant to the said "plan of reorganization", the petitioner received from its stockholders on or before October 2, 1939, a total of 4,000 shares of its previously outstanding common capital stock, being four-fifths of the previous holdings of each stockholder, and held the same in its treasury available for cancellation. Shortly after that date, the petitioner issued, to each person who had so surrendered four-fifths of the shares held by him or by her, "registered notes" in the form shown in Exhibit

4-D annexed hereto, in aggregate face values equal to the aggregate par values of the shares so surrendered. Said "notes" bore date of October 2, 1939, which was the first business day of the petitioner's fiscal year ended September 30, 1940, October 1, 1939, having fallen on Sunday. The aggregate amount of the petitioner's "registered notes" thus issued in the form shown as Exhibit 4-D annexed hereto was $400,000.

Thereupon, at a meeting duly held of the petitioner's board of directors, on October 10, 1939, the consummation of the said exchange was reported and a further vote was had with respect to the retirement of said 4,000 shares and the reduction accordingly of the petitioner's outstanding capital stock, all as set forth in Exhibit 11-K annexed hereto.

Thereupon, on October 10, 1939, the president and treasurer of the petitioner, together with a majority of its board of directors, duly executed and filed with the Commissioner of Corporations and Taxation of the Commonwealth of Massachusetts, the Articles of Amendment embodying said reduction of capital, as required by the laws of the Commonwealth of Massachusetts, and the same were thereafter approved by the said Commissioner of Corporations and Taxation. A copy of said articles of amendment, with the Commissioner's said approval, is annexed hereto, marked Exhibit 5-E.

X. Due to delay in printing, the said "registered notes" of the petitioner, dated October 2, 1939, were not actually signed and delivered at the time that the shares of stock, exchanged for the same, were surrendered to the petitioner and cancelled and retired as above. All such "registered notes" were signed and delivered to the proper recipients by November 14, 1939. Subject only to this delay in actual delivery, said "registered notes" in the aggregate sum of $400,000 were outstanding, in the form annexed hereto as Exhibit 4-D, during the petitioner's entire fiscal year ended September 30, 1940. By inadvertence the petitioner was described in said form of "note" as "Talbot Mills, Inc.", whereas

the petitioner's correct corporate name is "Talbot Mills". Respondent does not contest the issues because of this misnomer.

XI. At a meeting, duly held, of the petitioner's board of directors, on September 17, 1940, it was—

> "VOTED: That the Treasurer of this corporation be and he hereby is authorized and directed to fix, as soon after the close of the current fiscal year as possible, as of the close of the current fiscal year, the rate of interest upon the registered notes of this corporation earned and accrued for and on account of the current fiscal year."

See further Exhibit 13-M annexed hereto.

Thereafter there were assembled by the petitioner's treasurer, with the assistance of the petitioner's regularly employed auditors, the figures relative to the petitioner's earnings for the fiscal year just ended, being the year in question in this case. The petitioner's computation showed a total "profit", computed in accordance with the requirements set forth in the "notes", for the fiscal year ending September 30, 1940, in the amount of approximately $197,464.14.

Thereupon, at a meeting duly held of the petitioner's board of directors, on November 27, 1940, the petitioner's treasurer reported that

> ". . . he had ascertained and fixed at 10 per cent the rate of interest applicable to the registered notes of this corporation for and on account of the fiscal year ended September 28, 1940, such rate of 10 per cent being a rate less than that computable with reference to the net earnings of said fiscal year under the terms of said notes and being the maximum rate provided by the terms of said notes.
>
> And thereupon, upon motion duly made and seconded, it was,
>
> VOTED: That the determination by the Treasurer as aforesaid be and hereby is accepted and approved."

See further Exhibit 14-N annexed hereto.

At the directors' meeting last mentioned, it was also voted to defer the payment of three-fourths of said "interest" which, under the terms of said "notes", would become payable (unless deferred) on December 1, 1940. At a directors' meeting on March 28, 1941, said deferment was partially terminated and at a directors' meeting on September 15, 1941, said deferment was wholly terminated.

XII. By votes of the petitioner's directors, at meetings duly held on October 10, 1939, and November 27, 1939, the said $400,000 of "registered notes" of the petitioner were subordinated as to both principal and interest to indebtedness of the petitioner maturing not later than December 1, 1964 to the First National Bank of Boston then in amounts as follows: $50,000, bearing interest at 4 per cent per annum, and $30,000, secured by life insurance as collateral and bearing interest at 3 per cent per annum and the New England Trust Company then in the amount of $50,000, and bearing interest at 4 per cent per annum, or either of them, and the petitioner executed and delivered an agreement dated October 10, 1939, with the said banks. A copy of said agreement is annexed hereto marked Exhibit 6-F. Said agreement was authorized by said meeting of October 10, 1939, and adopted and ratified by said meeting of November 27, 1939. At the same meetings the said "registered notes" of the petitioner were also voted to be subordinated to the then existing loan of Parker Wilder & Co. in the amount of $100,000, and bearing interest at 6 per cent. The said registered notes have not been subordinated to any other indebtedness of the petitioner. The subordinations have since been terminated after payment of the senior obligations above referred to.

XIII. If the court finds that the item of $40,000 hereinbefore described or any part thereof did constitute interest and was properly denoted as such, within the meaning of Section 23 (b) of the Internal Revenue Code, and was, in fact, to any extent an obligation of the petitioner, then it is agreed that it was to that extent an obligation during the fiscal year ending September 30, 1940, and that said amount to that extent was properly and correctly

accrued for and on account of said fiscal year in pursuance of that obligation.

XIV. Income was reported by petitioner in its Federal tax returns, and dividends were paid, in the fiscal years ending September 30, 1932 to 1942, inclusive, as follows:

Year	Income	Dividends Paid
1932	$(236,559.74)	10,000.00
1933	(55,175.58)	none
1934	(142,971.56)	none
1935	1,645.43	none
1936	(14,813.33)	none
1937	(86,320.92)	none
1938	(164,303.95)	none
1939	118,627.94	none
1940	156,328.27*	none
1941	368,518.48*	none
1942	351,087.96*	20,000.00

* As reported by petitioner after deducting the $40,000 interest in dispute.

XV. Notes and accounts payable at the close of the fiscal year September 30, 1932, to 1942, inclusive, other than the notes here in issue were in total amounts as follows:

Year	Amount
1932	$106,048.83
1933	218,072.98
1934	200,060.56
1935	236,680.52
1936	146,699.39
1937	214,163.28
1938	421,180.08
1939	538,223.36
1940	491,778.44*
1941	494,568.61*
1942	241,027.58*

* Excludes $400,000 notes here in issue.

XVI. Interest on the notes here in issue was paid as follows:

	Date Paid	Amount Paid
Accrued in fiscal year Sept. 30, 1940—40,000	Dec. 2, 1940	10,000.00
	Mar. 27, 1941	10,000.00
	Sept. 15, 1941	20,000.00
Accrued in fiscal year Sept. 30, 1941—40,000	Dec. 1, 1941	10,000.00
	Feb. 26, 1942	10,000.00
	May 29, 1942	20,000.00
Accrued in fiscal year Sept. 30, 1942—40,000	Dec. 1, 1942	40,000.00

XVII. Interest on notes payable, as shown by petitioner's books for the fiscal year ending September 30, 1940, was as follows:

Date of Note	Payable to	Face	Rate %	Amount	Total
7/20/39	New England Trust Co.	$50,000.	4	$109.55	
10/28/39	New England Trust Co.	50,000.	4	500.00	
1/18/40	New England Trust Co.	50,000.	3½	442.36	
4/26/40	New England Trust Co.	50,000.	3½	442.36	
7/18/40	New England Trust Co.	50,000.	3½	350.00	
7/20/39	The First National Bank of Boston	50,000.	4	109.55	
7/12/39	The First National Bank of Boston	35,000.	3	306.45	
10/28/39	The First National Bank of Boston	50,000.	4	500.00	
(1) 1/30/40	The First National Bank of Boston	35,000.	2½	442.36	
1/18/40	The First National Bank of Boston	50,000.	3½	442.36	
4/26/40	The First National Bank of Boston	50,000.	3½	442.36	
(1) 7/13/40	The First National Bank	40,000.	2½	216.65	
7/18/40	The First National Bank	50,000.	3½	350.00	
	Total Interest on Notes Payable				$4,654.00

(1) Secured by pledge of life insurance policies.

	%	Total
Interest on Wool Purchasers (Paid to Parker Wilder & Co.)	6	$9,332.75
Interest on Parker Wilder Current Account	6	20,851.05
(2) Interest on Machinery Loan (Paid to Parker Wilder & Co.)	6	3,558.34
Interest on U. S. Marine Corp. Claim	6	378.69
Interest on Additional Tax Assessments	6	12.68
Sub-Total		$38,787.51
(3) Interest on Registered Notes $400,000.	10	40,000.00
Total Interest Expense		$78,787.51

XVIII. Minutes of stockholders' and directors' meetings of the Talbot Mills are annexed hereto as follows:

Stockholders,

Meeting of September 29, 1939, Exhibit 7-G

Directors,

Meeting of May 8, 1939	Exhibit 8-H
Meeting of Sept. 14, 1939	Exhibit 9-I
Meeting of Sept. 29, 1939	Exhibit 10-J
Meeting of Oct. 10, 1939	Exhibit 11-K
Meeting of Nov. 27, 1939	Exhibit 12-L
Meeting of Sept. 17, 1940	Exhibit 13-M
Meeting of Nov. 27, 1940	Exhibit 14-N
Meeting of Mar. 28, 1941	Exhibit 15-O
Meeting of Sept. 15, 1941	Exhibit 16-P
Meeting of Nov. 24, 1941	Exhibit 17-Q

MELVILLE F. WESTON,
Counsel for Petitioner.

J. P. WENCHEL,
Chief Counsel, Bureau of Internal Revenue,
Counsel for Respondent.

---

(2) Subordinated to bank loans.

(3) Subordinated to bank loans and Parker Wilder machinery loan.

EXHIBIT 3-C.

PLAN OF REORGANIZATION DATED SEPTEMBER 14, 1939

The following Plan of Reorganization is submitted for adoption by the directors and stockholders of the corporation. It is desirable, and therefore provided, that it shall be adopted only by affirmative vote of a majority of the board of directors and unanimous affirmative vote of the stockholders voting at a special meeting of stockholders to be called for the purpose. The plan calls for the recapitalization of the corporation by two steps, which are summarized as follows:

Step 1. The exchange by the corporation with each stockholder, for four-fifths (4/5ths) of such stockholder's holdings of the capital stock of the corporation, of registered notes of the corporation in the form of the draft form of note annexed hereto and in aggregate face value equal to the aggregate par value of the stock so taken in exchange. It is provided that the exchange shall be made only at such time as every stockholder shall have deposited with the corporation certificates of stock representing four-fifths (4/5ths) of the stock standing in his name upon the Stock Transfer Book of the corporation, accompanied by his irrevocable power of attorney authorizing any officer of the corporation to exchange such stock for notes of the corporation as above provided when like deposit, accompanied by a like power of attorney, shall have been made by all the stockholders of the corporation. It is further provided that, unless such deposits of stock shall have been made by all stockholders on or before October 2, 1939, the plan shall be deemed to have been abandoned, and all stock and powers of attorney deposited under it shall be returned to the stockholders entitled to the same, except that the board of directors may vote to extend the time for a period not exceeding thirty (30) days and if all the required stock has been deposited within such period such exchange may be made, effective as of said October 2, 1939.

Step 2. The reduction of the capital of the corporation to the extent of the par value of the shares taken in exchange for notes pursuant to Step 1, by the cancellation of such shares, the filing of articles of amendment setting forth such reduction of capital as required by Massachusetts law.

TALBOT MILLS, Inc.

By:— Treasurer.

Appended hereto was the draft form of "Registered Note due December 1, 1964", identical with the form of note annexed to the petition on file in this case marked "Exhibit B", and being also Exhibit 4-D annexed hereto.

EXHIBIT 4-D.

Talbot Mills, Inc.

REGISTERED NOTE DUE DECEMBER 1, 1964

$..... No.....

North Billerica, Mass., October 2, 1939.

For Value Received, the undersigned, Talbot Mills, Inc., hereinafter called the corporation, hereby promises to pay to

.....(Name of Payee)

.....(Address)

or assigns the sum of Dollars on December 1, 1964 (with the right to make payment earlier, as hereinafter provided), with interest payable at the dates and in the amounts hereinafter set forth for such time as said principal sum or any part thereof may remain unpaid. Both principal and interest are payable at the principal office of the company in North Billerica, Massachusetts, or at the Union Old Lowell National Bank in Lowell, Massachusetts. This note is one of a series of notes aggregating in total principal amount the sum of Four Hundred Thousand ($400,000) Dollars, all dated October 2, 1939, and having the same maturity and the same provisions relative to interest (the notes of such series being hereinafter sometimes called "these notes").

Interest hereon shall be payable annually on December 1 of each year for and on account of the fiscal year of the corporation ended last previous to such December 1, the first such date for the payment of interest being December 1, 1940 at a rate which shall not exceed 10 per cent nor be less than 2 per cent and, subject to these limitations, shall be a rate computed as follows:—There shall be taken a sum equal to two-thirds (2/3ds) of the net earnings of the corporation for the fiscal year ended last previous to such December 1, computed in accordance with the regular bookkeeping methods and practices of the corporation as established from time to time in good faith by its directors and officers but without deduction for federal income taxes paid or accrued and without deduction for interest upon these notes, and the rate of interest shall be the rate, figured to the nearest one-quarter per cent (1/4%) which such sums would represent as interest upon an assumed principal sum of Four Hundred Thousand ($400,000) Dollars. Provided, nevertheless, that from and after the close of the fiscal year ended next previous to December 1, 1964, and for such further time as this note shall remain unpaid, interest shall be at the rate of six per cent (6%) per annum, and such interest to December 1, 1964 shall be included in the installment payable at that date.

The corporation shall have the power, by vote of its Board of Directors, to defer the payment of all or part of any annual installment of interest for such time as the directors may in good faith determine to be necessary by reason of the condition of the corporation, without incurring liability for interest upon such deferred installment of interest, provided that such suspension of payment shall in no wise relieve the corporation of the obligation to pay the amount suspended at some future time and shall in no event operate to defer payment beyond December 1, 1964. The corporation covenants that it will pay no dividends upon any shares of stock of the corporation unless and until all then due interest upon these notes, including interest which may have been postponed as aforesaid, shall have been paid in full.

In the event of bankruptcy, receivership or like proceeding, dissolution or any liquidation, whether voluntary or involuntary, of the corporation, the principal sum hereof shall become immediately due and payable, together with all interest accrued to such date and unpaid, including interest at six per cent (6%) per annum for the period from the close of the fiscal year ended next previous to such event to the date of such event, and notwithstanding any vote of postponement affecting any accrued and unpaid interest.

No mortgage of the real estate of the corporation or of its machinery and equipment, to secure an obligation any part of which matures subsequent to December 1, 1964, other than a purchase money mortgage, shall at any time be made while any of these notes shall be outstanding, without the consent in writing of the holders of at least three-fifths (3/5ths) in amount of the total amount of these notes at the time outstanding.

The corporation shall have authority, by vote of its board of directors, to subordinate all of these notes as to both principal and interest to any other indebtedness of the corporation maturing not later than December 1, 1964, existing at or after the time of such vote and described therein by specific reference or in general terms, and such vote shall (whether any formal subordination agreement be executed or not) be effective to bind each holder of any of these notes to such subordination, with the same full force and effect as if such holder had directly entered into an agreement for subordination in accordance with the terms of such vote; and the corporation shall further have authority to enter into a formal subordination agreement with any creditor or creditors to the indebtedness to whom these notes shall so have been subordinated, which agreement shall contain the terms of such vote of subordination and such other and further appropriate terms and provisions as may be required by such creditor or creditors; and each holder of this note, by acceptance hereof, does irrevocably appoint the corporation his agent and attorney in fact to effect such subordination, without the necessity of any other or further

act, by means of such vote as aforesaid, and also, in the event that a formal subordination agreement be required by any creditor or creditors as above set forth, to enter into and execute such subordination agreement in such wise as fully to bind such holder to all the terms and provisions thereof as if executed by him as a principal, provided that no such subordination agreement shall impose upon any holder of any of these notes any personal liability other or further than the liability to pay or deliver to such creditor or creditors, so long as the indebtedness to such creditor or creditors to which these notes shall have been subordinated shall remain unsatisfied, any sum or sums or any security or securities or other property which shall be paid or delivered to such holder by the corporation or in connection with the reorganization of the corporation on account of or in substitution for any of these notes. No director or officer of the corporation shall be disqualified from acting as such director or officer in any vote or agreement of subordination by reason of being the creditor or one of the creditors to the indebtedness to whom these notes are subordinated by such vote or agreement.

Except as otherwise provided in a subordination vote or agreement at the time outstanding and in force, the corporation may at any time pay and retire these notes at par plus all interest accrued and unpaid, including interest at the rate of six per cent (6%) per annum for the period from the close of the fiscal year ended next previous to the date designated for payment to such date for payment, provided that if it pays and retires at one time less than all of the like notes at the time outstanding, it shall pay such proportion of the notes held by each record holder thereof as the aggregate amount which the corporation has elected to pay bears to the total aggregate of notes then outstanding. Notice of the election and intention of the corporation to make such payment shall be given by mail to the registered holders of the notes on a date at least thirty (30) days prior to the date designated in said notice as the date of payment, and if at the expiration of such thirty-day period of notice this note shall not have been pre-

sented by the holder for payment as aforesaid, then the corporation shall deposit in any national bank or trust company in Lowell, Massachusetts or Boston, Massachusetts, in the name of, or for the use and benefit of, the record holder of this note the entire amount required for making payment thereon in accordance with such notice, and upon such notice being duly given and payment made or such deposit made, all liability under this note shall thereupon cease and determine, provided that if less than the full face of the note shall have been called for payment, a new note for the uncalled balance, in all respects identical herewith except for the lesser principal sum, shall be executed and delivered to such holder upon the surrender of this note, or the corporation may at its option stamp the amount paid on the previously outstanding note, whereupon said note shall remain in force and effect as modified thereby.

In the event of any change in the fiscal year of the corporation the earnings of the corporation, for the purpose of the computation of the rate of interest due on these notes, shall continue to be computed on the basis of the fiscal year of the corporation as in force at the time of the issuance of these notes, provided that with the consent of the holders of three-fifths (3/5ths) in amount of the total amount of these notes at the time outstanding, appropriate provisions may be made for altering the dates for the payment of interest and periods for the computation of the rate of interest to conform to any changed fiscal year which the corporation may have adopted. With the written consent of the corporation and of the holders of three-fifths (3/5ths) in amount of the total amount of these notes at the time outstanding, filed with the corporation, any of the terms and provisions of this series of notes may be altered or amended so as to bind the corporation and every holder, whether consenting or not, provided that no such change shall:—(a) extend the date for the maturity of the principal of the notes; (b) alter the rate of interest or the method of computing the rate of interest, except in so far as required for an adjustment to a changed fiscal year as above; (c) diminish the

principal amount payable at maturity or the amount to be paid upon any earlier payment as above provided; or (d) vacate or diminsh the effect of any subordination previously voted and in force.

This note is transferable only by the owner hereof, by endorsement at the back hereof in the form provided for the purpose, and upon notation of such transfer hereon by the corporation by the clerk of the corporation or some other agent duly designated by vote of its directors for such purpose (who may, but need not be, a director or officer or employee of the corporation). The corporation may deem and treat the person in whose name this note is registered as the absolute owner hereof for the purpose of receiving payments of or on account of the principal and interest due hereon and for all other purposes, and shall not be required to recognize any other person whatsoever. Upon any transfer, the corporation may, but shall not be required to, issue a new note for a principal sum equal to the aggregate of any two or more notes presented to it for transfer, or issue two or more notes for an aggregate principal sum equal to the principal sum of one note so presented to it for transfer. Every transferee or other holder, by accepting this or any substitute note, shall by force thereof be deemed irrevocably to consent and agree to all the terms of such note and to all the terms and provisions of any vote or agreement of subordination which before such acceptance has been, or which shall thereafter be, passed or entered into pursuant to the terms of such note or of any previously outstanding note of this series, and to agree that no director, officer, agent or shareholder of the corporation shall be held, either directly or indirectly, or through any trustee, receiver or assignee, or through any proceeding, legal or equitable, to any personal liability, by reason of any agreement herein. In the event that any note shall appear to have been lost or destroyed, the corporation shall have the right, but shall not be required, to issue a substitute note upon such terms and conditions, as to indemnity or otherwise, as the corporation by vote of its Board of Directors may prescribe. In every case in which

a substitute note shall be issued, whether to take the place of a note said to be lost or destroyed or upon a transfer or to take care of an uncalled balance or otherwise, the corporation shall have the right to make upon such substitute note any and all endorsements or entries which, consistent with the general terms and provisions hereof, it may deem needful or appropriate for the protection of the corporation against any duplication of liability, either as to principal or interest, by reason of the issuance of such substitute note.

In Witness Whereof, Talbot Mills, Inc. has caused these presents to be executed in its name and behalf and its corporate seal to be hereto affixed by its duly authorized officer or officers as of October 2, 1939.

TALBOT MILLS, Inc.

Signed by _____, Treasurer

Countersigned by _____, President

Identified as one of the series of notes hereinbefore referred to:

Clerk or Other Agent
Designated by the Directors as above.

Signature of Transferor	Name of Transferee	Address of Transferee	Date of Transfer	The Within Transfer of This Note Is Authenticated

Clerk or Other Agent of the Corporation Designated by the Directors

EXHIBIT 5-E.

The Commonwealth of Massachusetts
Department of Corporations and Taxation
Henry F. Long, Commissioner
236 State House, Boston

REDUCTION OF CAPITAL

The fee for filing to accompany this certificate is $10.00. Checks should be made payable to The Commonwealth of Massachusetts.

This certificate must be submitted to the Commissioner of Corporations and Taxation within thirty days after the date of the meeting at which the amendment was adopted. Section 43, Chapter 156, General Laws, Ter. Ed.

Articles of Amendment

We, Thomas Talbot Clark President and Treasurer and J. Colby Bassett Lincoln Clark John M. Eaton M. Allison Taylor being a majority of the directors of Talbot Mills, Inc. located at North Billerica, Massachusetts in compliance with the provisions of chapter 156 of the General Laws, Tercentenary Edition, do hereby certify that at a meeting of the stockholders of the corporation, duly called for the purpose, held September 29 1939, and by the affirmative vote of 5,000 shares of the common stock of the corporation, being at least a majority of all the stock outstanding and entitled to vote, the following amendment authorizing a reduction in the capital stock of the corporation was duly adopted, namely:

[Here insert an exact copy of the vote or votes authorizing the reduction.]

the capital stock of this corporation be and hereby is reduced from $500,000, consisting of 5,000 shares of $100.00 par value each, to $100,000, consisting of 1,000 shares of $100.00 par value each, such reduction to be effected by the cancelling and retiring of 4,000 shares heretofore issued and outstanding which are presently to be acquired by the corporation in

exchange for a certain issue of registered notes of the corporation;

the Agreement of Association and Articles of Organization of this corporation, as heretofore amended, be and each hereby is further amended by striking out the provisions thereof stating the total amount of its authorized capital stock, the par value of its shares and the number of its shares, and by substituting therefor the following:

"The total authorized capital stock with par value is $100,000—the par value of its shares is Common $100.00—the number of its shares with par value is Common 1000."; and

Articles of Amendment be prepared executed and filed as required by law, setting forth the foregoing reduction of capital;

provided that this vote shall, without the necessity of other or further action by the stockholders, take effect at such time as the corporation shall by the exchange of its registered notes for stock as above referred to * have acquired and hold in its treasury, available for cancellation to accomplish the purposes of this vote, 4,000 shares of its presently outstanding common capital stock, the time of such acquisition and hence the effective time of this vote to be conclusively determined by the action of the proper officers of the corporation in including in the Articles of Amendment "Reduction of Capital", to be filed as aforesaid, a statement ** with respect to the same.

---

* The reference is to a vote earlier at the same meeting adopting a plan of reorganization which called for the issue of a series of registered notes in exchange for 4000 shares of capital stock.

** Pursuant to this authority it is hereby stated that said 4000 shares of common capital stock were by such exchange duly acquired and held in the company's treasury, available for cancellation to accomplish the purposes of the above vote on October 2, 1939 and that the above vote hence took effect on October 2, 1939.

That the total amount of capital stock already authorized is

None shares preferred.
5000 shares common.
None shares without par value.

That the amount of capital stock already issued is

None shares preferred.
5000 shares common.
None shares without par value.

That the amount of reduction of capital stock with par value now authorized by the stockholders is $400,000 consisting of 4000 shares of $100 par value each.

The manner in which said reduction will be effected is as follows: By cancelling 4000 shares acquired by the corporation in exchange for an issue of its notes, as set forth above.

In Witness Whereof, we have hereto signed our names Under the Penalties of Perjury, this 10th day of October in the year 1939.

THOMAS TALBOT CLARK, Pres. Treas. & Director
J. COLBY BASSETT, Director
LINCOLN CLARK, Clerk & Director
JOHN M. EATON, Director
M. ALLISON TAYLOR, Director

(CORPORATE)
(SEAL)

[On back:]

Write Nothing Below
Talbot Mills
fee $10. paid
Articles of Amendment—Reduction of Capital

General Laws, Ter. Ed., Chapter 156, Section 45 Filed in the office of the Secretary of the Commonwealth, October 11, 1939

I hereby approve the within certificate, this 11th day of October 1939

HENRY F. LONG
Commissioner of Corporations and Taxation

(EXCERPTS FROM) EXHIBIT 6-F.

An Agreement made this 10th day of October, 1939, by Talbot Mills, Inc. (hereinafter called the "Mills") and the holders of notes of the series hereinafter described (hereinafter called the "Noteholders") with The First National Bank of Boston and The New England Trust Company (hereinafter called the "Banks").

Whereas the Mills is indebted to each of the Banks in the amount of fifty thousand dollars ($50,000), and may hereafter become indebted to the Banks for further advances (said present indebtedness, whether represented by the notes now outstanding or by any notes or obligations given in renewal thereof or in substitution therefor, together with all future indebtedness to the Banks maturing not later than December 1, 1964, or either of them, and all interest accrued or accruing on any such indebtedness, being hereinafter called the "Bank Indebtedness"), and has outstanding a series of promissory notes in the aggregate amount of four hundred thousand dollars ($400,000), all dated October 2, 1939, and maturing December 1, 1964 (hereinafter called the "Notes"); and

Whereas each of the Notes provides in substance that the holder, by the acceptance thereof, authorizes the Mills, by vote of its Board of Directors, to subordinate the Notes to any indebtedness of the corporation existing at the time of such vote or thereafter arising, and further authorizes the Mills to execute a subordination agreement containing such appropriate terms and provisions as may be required by any creditor or creditors of the Mills to the indebtedness to whom the Notes have been so subordinated; and

Whereas the Mills, by vote of its Board of Directors as duly passed at a meeting held on October 10, 1939, has subordinated all of the Notes to the Bank Indebtedness, and the Banks have required the execution and delivery of this agreement of subordination as a condition of their refraining from demanding payment of the Bank Indebtedness;

Now, Therefore, this agreement witnesseth that in consideration of the premises, and in order to induce the Banks not to demand payment, the Mills and the Noteholders agree with the Banks as follows:

1. The indebtedness represented by the Notes is hereby subordinated, both as to principal and interest, to the Bank Indebtedness.

2. So long as any part of the Bank Indebtedness shall remain unsatisfied, the Noteholders will not, without the prior written consent of each of the Banks, demand, accept or receive from the Mills any payment of principal of or interest on or any collateral or other security for the Notes held by them respectively, or any other notes or obligations in renewal of or in substitution therefor, except, pursuant to the exchange provisions contained in the Notes, another Note of the same tenor, and the Mills will not, without such written consent, pay any amount on account of the principal of or interest on, or give any collateral or other security for, any of the Notes or give any other Notes or obligations in renewal thereof or in substitution therefor, except as aforesaid, to any Noteholders.

3. In the event of any petition in bankruptcy being brought by or against the Mills, and in the event of any other proceedings for the liquidation of the Mills, either by its voluntary action or otherwise, the Noteholders will assign and pay over to the Banks, ratably in proportion to the amount of the Bank Indebtedness owed to them respectively, to the extent necessary to satisfy the Bank Indebtedness in full, any and all distributions and payments in respect of the Notes to which the Noteholders would be entitled in any such proceedings.

4. In the event of any proceedings affecting the Mills under any bankruptcy or insolvency laws, or any laws relating to the relief of debtors, readjustment, composition or extension of indebtedness, or reorganization of corporations or other debtors, any payment to which the Noteholders would be entitled under any plan of reorganization approved by the court shall be paid to the

Banks, ratably in proportion to the amount of the Bank Indebtedness owed to them respectively, to be applied on the Bank Indebtedness, and any securities or other property issued or issuable to the Noteholders under any such proceedings shall be assigned and delivered to the Banks ratably in proportion to the amount of the Bank Indebtedness owed to them respectively, to be held by them subject to the same terms of subordination to the Bank Indebtedness as are created by this instrument with respect to the Notes.

5. In order to carry out the terms and intent of this agreement more effectively, the Noteholders will do all acts necessary or convenient to preserve for the Banks the benefits of this subordination agreement, and will execute all agreements which the Banks may request for that purpose; provided, however, that no such agreement shall impose upon any Noteholder any personal liability other or further than the liability to pay or deliver to the Banks, so long as any part of the Bank Indebtedness shall remain unsatisfied, any sum or sums or any security or securities or other property which shall, contrary to the provisions of paragraph 2 above, be paid or delivered to such Noteholder by the Mills, or in connection with the liquidation or reorganization of the Mills, on account of or in substitution for any of the Notes. The Noteholders hereby authorize the Banks to—

(*a*) Collect any distributions or payments which would otherwise be payable to the Noteholders on any liquidation of the Mills, or in any proceedings affecting the Mills under any bankruptcy or insolvency laws or laws relating to the relief of debtors, readjustment, composition or extension of indebtedness, or reorganization of corporations or other debtors.

(*b*) Prove the claims of the Noteholders in any such proceedings.

(*c*) Accept or reject, to the extent to which the Noteholders would be entitled to accept or reject, any plan of reorganization in any such proceedings.

(*d*) Accept any new securities or other property to which the Noteholders would otherwise be entitled under any such plan of reorganization or proceedings.

(*e*) In general to do any act in connection with such proceedings which the Noteholders might otherwise do, it being understood that the Banks shall account to the Noteholders for any amounts in excess of the amount necessary to satisfy the Bank Indebtedness which may be received by them respectively from any distributions or payments in any such proceedings or in respect of any securities received in any such proceedings, and shall likewise account to the Noteholders for all such securities or other property received by the Banks, but the Banks shall have no duty as to the collection or protection of securities so received by them, or any income thereon, nor as to the preservation of any rights pertaining thereto, but only for the safe custody thereof.

6. At any time when there shall be no Bank Indebtedness, as hereinbefore defined, existing and unsatisfied, the Mills may, in behalf of itself and in behalf of the Noteholders, give to the Banks written notice of the termination of this agreement and thereafter this agreement shall not be applicable to any new loans which may thereafter be made to the Mills by the Banks.

In Witness Whereof said Talbot Mills, Inc. has caused these presents to be executed by Thomas Talbot Clark, its Treasurer, and its corporate seal to be hereto affixed and attested by Lincoln Clark, its clerk, both in its individual capacity and as agent and attorney for the Noteholders, pursuant to the power to that end conferred on it by the terms of the Notes, the day and year first above written.

TALBOT MILLS, Inc.
By Thomas Talbot Clark
its Treasurer.

Attest: /s/ LINCOLN CLARK Clerk

* * * * * *

AGREEMENT SUPPLEMENTAL TO AGREEMENT OF OCTOBER 10, 1939, BY TALBOT MILLS, INC. WITH THE FIRST NATIONAL BANK OF BOSTON AND THE NEW ENGLAND TRUST COMPANY

This Agreement made this 27th day of November, 1939, by Talbot Mills, Inc. (hereinafter called the "Mills") and the holders of its notes of the series dated October 2, 1939 (hereinafter called the "Noteholders") with The First National Bank of Boston and The New England Trust Company (hereinafter called the "banks").

Witnesseth That:

Whereas the Mills and the Noteholders (acting by the Mills as agent and attorney-in-fact for the Noteholders) have executed and delivered to the Banks a certain subordination agreement dated October 10, 1939; and

Whereas further corporate action has been required by the Banks for the purpose of further assurance of such subordination; and

Whereas at a meeting of the Board of Directors of the Mills, duly held November 27, 1939, such further corporate action was taken as follows:

> "It was reported to the meeting that subsequent to the directors' meeting of October 10, 1939, and pursuant to the action taken at that meeting, the Treasurer of this corporation had executed and delivered a subordination agreement with The First National Bank of Boston and The New England Trust Company, substantially in the form submitted to the said meeting of October 10, 1939; that thereafter some question had arisen with respect to the efficacy of the same in view of the circumstances that the $400,000 of registered notes of the corporation dated October 2, 1939, were not actually signed and delivered until subsequent to said meeting of October 10, 1939; that for this reason the said Banks have required, as a condition of their refraining from demanding

payment of this corporation's indebtedness to them, that further corporate action be taken for the purpose of further assurance of such subordination; and that the said $400,000 of registered notes have, previous to this meeting, been signed and delivered. Thereupon, and in consideration of the premises, upon motion duly made and seconded, it was unanimously

"Voted: That (without in any wise imputing invalidity or inadequacy to the vote of the directors at their meeting of October 10, 1939, or the subordination agreement of that date) in pursuance of the powers granted or reserved to this corporation in each of its notes of the series dated October 2, 1939, to be exercised by vote of its Board of Directors, all of the notes of said series are hereby subordinated as to both principal and interest to all present and future indebtedness of the corporation maturing not later than December 1, 1964 to The First National Bank of Boston and The New England Trust Company, or either of them, and to all interest accrued or accruing on any such indebtedness, and further in pursuance of said powers that the Treasurer of the corporation be and hereby is authorized and instructed to execute and deliver for and in behalf of the corporation, both as principal and as agent and attorney-in-fact for all holders of the said notes dated October 2, 1939, a formal subordination agreement with the said Banks, in form similar to said subordination agreement of October 10, 1939, and further, in order that no actual re-execution of such subordination agreement may be necessary, that the said agreement dated October 10, 1939, as already executed and delivered, be and the same hereby is adopted as and for the present agreement of this corporation, made pursuant to this vote and to the authority hereby conferred, and that the Treasurer of this corporation be and hereby is authorized and instructed to execute and deliver to the said Banks a supplemental agreement of this corporation, reciting this vote and adopting the said agreement of

October 10, 1939 and all and every the terms and conditions thereof as and for the present agreement of this corporation and as and for a present exercise of every power vested in this corporation by the terms of the said notes whereby such subordination is authorized and enabled, and that the execution and delivery by the Treasurer of such agreement shall be sufficient evidence of its compliance with the provisions of this vote and sufficient evidence of his authority to act hereunder."; and

Whereas it is desired to make this supplemental agreement in accordance with the terms of the foregoing vote;

Now Therefore the Mills and the Noteholders, in consideration of the premises and in order to induce the Banks not to demand payment of the Bank Indebtedness (as that expression is used in said agreement dated October 10, 1939) hereby agree with the Banks as follows:

The said subordination agreement dated October 10, 1939, is hereby adopted as and for the agreement of the Mills and of the Noteholders with the Banks with precisely the same full force and effect as if an agreement identical in terms therewith had been this day executed and delivered; and each and every term and condition of the said agreement dated October 10, 1939 is by reference incorporated herein and made a part hereof and shall be binding upon, and inure to the benefit of, the parties in accordance with the tenor thereof.

In Witness Whereof said Talbot Mills, Inc. has caused these presents to be executed by Thomas Talbot Clark, its Treasurer, and its corporate seal to be hereto affixed and attested by Lincoln Clark, its Clerk, both in its individual capacity and as agent and attorney-in-fact for the Noteholders, pursuant to the power to that end conferred upon it by the terms of the notes, the day and year above written.

TALBOT MILLS, Inc.

By: Thomas Talbot Clark (SEAL)

Its Treasurer

Attest: Lincoln Clark Clerk

Accepted

THE FIRST NATIONAL BANK OF BOSTON
By L. D. Brace Its Vice Pres.
THE NEW ENGLAND TRUST COMPANY
By Stanley A. Lawry Its Vice Pres.

* * * * * *

EXHIBIT 7-G.

September 29, 1939
September 22, 1939

Call for Stockholders' Meeting

To the Stockholders of Talbot Mills, Inc.

You are hereby notified that a special meeting of the stockholders of Talbot Mills, Inc., a Massachusetts corporation, will be held at the office of the corporation at its Mill in North Billerica, Massachusetts, on Friday, September 29, 1939, at 10.00 A.M., for the purpose of considering and acting upon a proposed plan of reorganization, approved and recommended to the stockholders for adoption by the directors of the corporation at a meeting held September 14, 1939, which plan contemplates the issue of Four Hundred Thousand Dollars ($400,000) principal amount of registered notes of the corporation in exchange for a like amount in par value of its capital stock, and the reduction of the capital of the corporation from Five Hundred Thousand Dollars ($500,000) to One Hundred Thousand Dollars ($100,000), to be accomplished by the cancellation of the stock so received in exchange, and for the further purpose of authorizing such action by the directors and officers of the corporation as may be necessary or convenient for the carrying into effect of said plan of reorganization or in any wise incidental thereto.

LINCOLN CLARK Clerk

September 29, 1939

A special meeting of the stockholders of Talbot Mills was this day held at the office of the corporation North Billerica, Mass. at 10 A.M.

The call for the meeting was mailed or delivered in person to each stockholder in accordance with the by laws and a copy of same will be found on page 32.

The meeting was called to order by the President Thomas T. Clark.

Present	No. of shares
M. Allison Taylor, Trustee Gert. Talbot Taylor	210
M. A. Taylor, Executor Estate of Gert. Talbot Taylor	60
M. A. Taylor	10
Harriet Talbot Parker	270
J. Colby Bassett	10
J. Colby Bassett, Treas. Moses Greely Parker Trust	555
Thomas T. Clark	460
Frederic S. Clark, Jr.	400
Lincoln Clark	400
Lincoln Clark & J. Colby Bassett	
Proxy for Grace T. Randall	1375
Proxy for Darley Randall	10
Proxy for Sydney S. H. Ewart	555
Proxy for Elizabeth T. Towne	50
John M. Eaton	5
John M. Eaton Proxy for Isabella H. Eaton	630
	5,000 shares

The clerk read the call for the meeting.

It was voted to dispense with the reading of the records of the previous meeting.

The Treasurer explained to the stockholders the Plan of Reorganization of the corporation which was approved, and recommended to the stockholders for adoption, by the Board of Directors at the directors' meeting held on September 14, 1939.

Thereupon, on Mr. Eaton's motion seconded by Mrs. Parker, it was unanimously

Voted: To approve and adopt the said Plan of Reorganization.

And further on Mrs. Parker's motion, seconded by Mr. Eaton, it was unanimously

Voted: That the officers and directors of the corporation, and any of them, be and hereby are authorized and instructed to take all steps necessary or convenient for the carrying into effect of the said Plan of Reorganization or in any wise incidental thereto, including, without limiting the generality of the foregoing, the execution in the name and behalf of the corporation of the notes therein referred to in the form therein provided, which is hereby approved, and the delivery of such notes in exchange for stock of the corporation, in accordance with the terms of said Plan of Reorganization.

Thereafter, on Mr. Bassett's motion, seconded by Mr. Taylor, it was unanimously

Voted: That, effective as hereinafter provided,

the capital stock of this corporation be and hereby is reduced from $500,000, consisting of 5,000 shares of $100.00 par value each, to $100,000, consisting of 1,000 shares of $100.00 par value each, such reduction to be effected by the cancelling and retiring of 4,000 shares heretofore issued and outstanding which are presently to be acquired by the corporation in exchange for a certain issue of registered notes of the corporation;

the Agreement of Association and Articles of Organization of this corporation, as heretofore amended, be and each hereby is further amended by striking out the provisions thereof stating the total amount of its authorized capital stock, the par value of its shares and the number of its shares, and by substituting therefor the following:

"The total authorized capital stock with par value is $100,000—the par value of its shares is Common $100.00—the

number of its shares with par value is Common 1000"; and Articles of Amendment be prepared, executed and filed as required by law, setting forth the foregoing reduction of capital;

provided that this vote shall, without the necessity of other or further action by the stockholders, take effect at such time as the corporation shall by the exchange of its registered notes for stock as above referred to have acquired and hold in its treasury, available for cancellation to accomplish the purposes of this vote, 4,000 shares of its presently outstanding common capital stock, the time of such acquisition and hence the effective time of this vote to be conclusively determined by the action of the proper officers of the corporation in including in the Articles of Amendment "Reduction of Capital", to be filed as aforesaid, a statement with respect to the same.

And further on Mr. Taylor's motion, seconded by Mr. F. S. Clark, Jr. It was unanimously

Voted: That in the event that the foregoing vote does not take effect in accordance with its terms within thirty (30) days from October 2, 1939, then the same shall be completely null and void.

Thereafter, no further business coming before the meeting, it was, upon motion duly made and seconded,

Voted: To adjourn.

Adjourned.

A true record.

Attest: LINCOLN CLARK Clerk

(EXCERPTS FROM) EXHIBIT 8-H.

May 8th, 1939

A meeting of the Board of Directors of Talbot Mills was this day held at the office of the Corporation, North Billerica, Mass. at 10 A.M.

* * * * * *

The President reported that the set of cards was purchased from the Ames Worsted Co., and would be running in two weeks.

The Treasurer reported that further efforts to sell mill tenements had produced no results.

* * * * * *

The Treasurer presented reports for the 4 weeks period ending April 15th, and for the six months period ending April 15th. He also explained that business was in a between season's slump, and that it might be necessary to shut the looms down within a week. Prospects for fall business are still fair.

On motion duly made and seconded

It was voted:—To accept the reports of the Treasurer.

Upon motion duly made and seconded, it was

Voted:—To authorize the Treasurer to retain counsel to examine the capital structure of the company with the view to seeing if any modification can be made in same to the advantage of the company.

Voted, To dissolve

A true record

Attest LINCOLN CLARK Clerk

(EXCERPTS FROM) EXHIBIT 9-I.

September 14, 1939

A meeting of the Board of Directors of Talbot Mills was this day held at the office of the Corporation, North Billerica, Mass. at 11 A.M.

* * * * * *

On Mr. Bassett's motion seconded by Mr. F. S. Clark, Jr.

It was Voted:—

That an appropriation of $25,000 for new machinery and improvements be authorized.

The Treasurer reported that the tenements and vacant land will be auctioned on Sept. 30th.

On Mr. Eaton's motion, seconded by Mr. Bassett

It was Voted:—

That the action of the Treasurer in disposing at auction of all property not needed for manufacturing purposes be approved.

On Mr. Bassett's motion seconded by Mr. Taylor,

It was Voted:—

That the plan of reorganization and form of note annexed hereto be adopted and approved and that its adoption be recommended to the stockholders.

On motion duly made and seconded,

It was Voted:—

That a Special Meeting of the Stockholders be called for Sept. 29th at 10 A.M., for the purpose of considering the Plan of Reorganization.

Voted to dissolve

A true Record

Attest LINCOLN CLARK Clerk

The "Plan of Reorganization" referred to in the foregoing is separately attached to this stipulation as Exhibit 3-C.

(EXCERPTS FROM) EXHIBIT J.

September 29, 1939

A meeting of the Board of Directors of Talbot Mills was this day held at the office of the Corporation, North Billerica, Mass. at 10:40 A.M. immediately following the Special Meeting of the stockholders,

* * * * * *

The meeting was informed with respect to the action taken by the stockholders of the corporation at their meeting held earlier this day, whereby the plan of reorganization, which was approved and recommended to the stockholders by this Board at its meeting held on September 14, 1939, was approved and adopted by the stockholders and certain votes were taken in pursuance thereof.

Thereafter upon motions duly made and seconded, it was unanimously

Voted: That the President and Treasurer of the corporation be and hereby are authorized and directed to execute in the name and behalf of the corporation notes in the form approved at the meeting of the stockholders held on September 29, 1939 in the aggregate principal amount of $400,000 and to deliver the same in exchange for stock of the corporation in accordance with the provisions of and subject to the conditions of the plan of reorganization adopted at said stockholders' meeting.

And further

Voted: That the Clerk of the corporation be and hereby is authorized and directed to act as the agent of the corporation for the authentication of notes issued under the foregoing vote and for the notation of any and all transfers thereof.

And further

Voted: That the officers of the corporation and any of them be and hereby are authorized and instructed to take all steps (not covered by the preceding votes) necessary or convenient for the carrying into effect of the said plan of reorganization or in any wise incidental thereto including, without limiting the generality of the foregoing, the making of the exchange provided by said plan of reorganization in accordance with the authority granted to such officers or any of them by the deposit agreements and powers of attorney relating to said plan of reorganization heretofore or hereafter filed with the corporation by its several stockholders.

On request the President retired from the meeting and the clerk presided.

On Mr. Bassett's motion seconded by Mr. Eaton

It was Voted:—

To pay to Thomas T. Clark, Treasurer, additional compensation of $1,000 because of the special services he has performed for the company in connection with the rehabilitation of the manufac-

turing plant and reorganization of the capital structure of the corporation.

The President then returned and was informed of the vote.

Voted To dissolve

A True Record

Attest LINCOLN CLARK Clerk

(EXCERPTS FROM) EXHIBIT 11-K.

October 10, 1939

A meeting of the Board of Directors of Talbot Mills was this day held at the office of the corporation, North Billerica, Mass. at 11 A.M.

* * * * * *

It was reported to the meeting that the exchange of notes of this corporation for stock, authorized by the plan of reorganization approved and adopted at the meeting of the stockholders on September 29, 1939, was completed on October 2nd, 1939 on which date the corporation acquired and held in its treasury available for cancellation four thousand (4000) shares of its previously outstanding common capital stock and that upon that date, therefore, the vote of the stockholders taken at their said meeting on September 29th, 1939 for the reduction of the capital stock of the corporation to $100,000, consisting of 1000 shares of $100 par value each, became effective.

Thereupon, on Mr. Bassett's motion, seconded by Mr. Taylor, it was unanimously

Voted: That the officers and directors executing the articles of amendment "Reduction of Capital" setting forth the reduction voted at a meeting of the stockholders of the corporation on September 29, 1939 be and hereby are authorized and directed to include in the said articles of amendment a statement that the corporation on October 2 1939 acquired and held in its treasury available for cancellation to accomplish the purposes of said reduction of capital four thousand

(4000) shares of its common capital stock outstanding on September 29, 1939, and that hence said reduction became effective on October 2, 1939.

It was reported to the meeting that the First National Bank of Boston and the New England Trust Company, to each of which banks the corporation is indebted in the principal amount of $50,000, have required as a condition of their refraining from demanding payment of said indebtedness and interest that the series of registered notes of this corporation dated October 2, 1939 be subordinated, as to both principal and interest, to this corporation's indebtedness to the said banks and likewise to any future indebtedness to the said banks maturing not later than December 1, 1964 and all interest accrued or accruing on any such indebtedness and have further required the execution and delivery of a formal subordination agreement in the form submitted to this meeting.

Thereupon, on Mr. Bassett's motion seconded by Mr. Eaton, it was unanimously

Voted: That in pursuance of the powers granted or reserved to the corporation in each of its notes of the series dated October 2, 1939, to be exercised by vote of its Board of Directors, all of the notes of said series are hereby subordinated as to both principal and interest to all present and future indebtedness of the corporation maturing not later than December 1, 1964 to the First National Bank of Boston and the New England Trust Company, or either of them, and to all interest accrued or accruing on any indebtedness, and further in pursuance of said powers that the Treasurer of the corporation be and hereby is authorized and instructed to execute and deliver for and in behalf of the corporation, both as principal and as agent and attorney in fact for all holders of the said notes dated October 2, 1939, a formal subordination agreement with the said banks containing the terms of this vote of subordination and such other and further appro-

priate terms and provisions as may be required by said banks, which agreement may be in the form or substantially the form submitted to this meeting, and that the execution and delivery by the Treasurer of said agreement shall be sufficient evidence of its compliance with the provisions of this vote and sufficient evidence of his authority to act hereunder.

And further, on Mr. Bassett's motion, seconded by Mr. Eatorf, it was unanimously

Voted: That in pursuance of the powers granted or reserved to the corporation in each of its notes of the series dated Oct. 2, 1939 to be exercised by vote of its Board of Directors, all of the notes of said series are hereby subordinated as to both principal and interest to the currently existing $100,000 machinery loan of Parker Wilder & Co. and that this subordination is junior to the subordinations previously voted in favor of the First National Bank of Boston and the New England Trust Co.

Voted To dissolve.

A True Record

Attest LINCOLN CLARK Clerk

(EXCERPTS FROM) EXHIBIT 12-L.

November 27, 1939

A meeting of the Board of Directors of Talbot Mills was this day held at the office of the corporation, North Billerica, Mass. at 10 A.M.

* * * * * *

On Mr. Bassett's motion seconded by Mr. Eaton, it was

Voted: To authorize the expenditure of $25,000 for new machinery, and it was further

Voted: To approve an additional expenditure of not exceeding $15,000 for improvements of buildings and equipment.

* * * * * *

It was reported to the meeting that subsequent to the directors' meeting of October 10, 1939, and pursuant to the action taken at that meeting, the Treasurer of this corporation had executed and delivered a subordination agreement with The First National Bank of Boston and The New England Trust Company, substantially in the form submitted to the said meeting of October 10, 1939; that thereafter some question had arisen with respect to the efficacy of the same in view of the circumstance that the $400,000 of registered notes of the corporation dated October 2, 1939, were not actually signed and delivered until subsequent to said meeting of October 10, 1939; that for this reason the said Banks have required, as a condition of their refraining from demanding payment of this corporation's indebtedness to them, that further corporate action be taken for the purpose of further assurance of such subordination; and that the said $400,000 of registered notes have, previous to this meeting, been signed and delivered. Thereupon, and in consideration of the premises, upon motion duly made and seconded, it was unanimously

Voted: That (without in any wise imputing invalidity or inadequacy to the vote of the directors at their meeting of October 10, 1939, or the subordination agreement of that date) in pursuance of the powers granted or reserved to this corporation in each of its notes of the series dated October 2, 1939, to be exercised by vote of its Board of Directors, all of the notes of said series are hereby subordinated as to both principal and interest to all present and future indebtedness of the corporation maturing not later than December 1, 1964 to The First National Bank of Boston and The New England Trust Company, or either of them, and to all interest accrued or accruing on any such indebtedness, and further in pursuance of said powers that the Treasurer of the corporation be and hereby is authorized and instructed to execute and deliver for and in behalf of the corporation, both as principal and as agent and attorney-in-fact for all holders of the said notes dated October 2, 1939, a formal subordination agreement with the said Banks, in form similar to said subordination agreement of October

10, 1939, and further, in order that no actual re-execution of such subordination agreement may be necessary, that the said agreement dated October 10, 1939, as already executed and delivered, be and the same hereby is adopted as and for the present agreement of this corporation, made pursuant to this vote and to the authority hereby conferred, and that the Treasurer of this corporation be and hereby is authorized and instructed to execute and deliver to the said Banks a supplemental agreement of this corporation, reciting this vote and adopting the said agreement of October 10, 1939 and all and every the terms and conditions thereof as and for the present agreement of this corporation and as and for a present exercise of every power vested in this corporation by the terms of the said notes whereby such subordination is authorized and enabled, and that the execution and delivery by the Treasurer of such agreement shall be sufficient evidence of its compliance with the provisions of this vote and sufficient evidence of his authority to act hereunder.

Thereafter, it was stated to the meeting that in view of the foregoing action, it was desirable to restate as of this date the subordination of the said notes to the indebtedness to Parker Wilder & Co., as voted at said meeting of October 10, 1939, and thereupon, upon motion duly made and seconded, it was unanimously

Voted: That in pursuance of the powers granted or reserved to the corporation in each of its notes of the series dated October 2, 1939, to be exercised by vote of this Board of Directors, all the notes of said series are hereby subordinated as to both principal and interest to the currently existing $100,000 machinery loan of Parker Wilder & Co., it being understood that the subordination hereby voted is subject and junior to the subordination to certain indebtedness to The First National Bank of Boston and The New England Trust Company as voted October 10, 1939, and as again voted earlier this day.

Voted To dissolve

A true Record

Attest LINCOLN CLARK Clerk

(EXCERPTS FROM) EXHIBIT 13-M.

Sept. 17, 1940.

A meeting of the Board of Directors of Talbot Mills was held this day at the office of the Corporation, No. Billerica, Mass. at 10:30 A.M.

* * * * * *

On motion of Mr. Eaton, seconded by Mr. Taylor it was

Voted That the Treasurer of this Corporation be and he hereby is authorized and directed to ascertain and fix, as soon after the close of the current fiscal year as possible, as of the close of the current fiscal year, the rate of interest upon the registered notes of this corporation earned and accrued for and on account of the current fiscal year.

* * * * * *

On Mr. L. Clark's motion, seconded by Mr. Taylor it was

Voted to authorize the expenditure of $55,000 for 5 tape condensers, 1 dry cleaner, and one fulling mill during the next fiscal year.

Voted to adjourn

A true record:

Attest LINCOLN CLARK Clerk

(EXCERPTS FROM) EXHIBIT 14-N.

Nov. 27, 1940

A meeting of the Board of Directors of Talbot Mills was held this day at the office of the Corporation, North Billerica, Mass. at 10 A.M.

* * * * * *

It was reported to the meeting by the Treasurer that, pursuant to the authority conferred upon him by vote of the Board at its meeting on September 17, 1940, he had ascertained and fixed at 10 per cent the rate of interest applicable to the registered notes of this Corporation for and on account of the fiscal year ended September 28, 1940, such rate of 10 per cent being a rate less

than that computable with reference to the net earnings of said fiscal year under the terms of said notes but being the maximum rate provided by the terms of said notes.

And thereupon, upon motion duly made and seconded, it was

Voted That the determination by the Treasurer as aforesaid be and hereby is accepted and approved.

Upon Mr. Eaton's motion, duly seconded, it was

Voted: To defer, pursuant to the terms of the registered notes due December 1, 1964, of this corporation, the payment of three-fourths of the annual installment of interest, for and on account of the fiscal year ended September 28, 1940, which under the terms of such notes becomes payable (unless deferred) on December 1, 1940, it being hereby determined by the Board that such deferment is necessary by reason of the condition of the corporation; and that such deferment shall continue to that date, not later than Dec. 1, 1964, at which, by further vote of the Board, it shall be determined that the need therefor has ceased.

The Treasurer reported the ability to pay all bank loans and the arrangement to borrow $400,000 at 3%.

* * * * * *

Voted to dissolve

A true record

Attest. LINCOLN CLARK Clerk

(EXCERPTS FROM) EXHIBIT 15-O.

March 28, 1941.

A meeting of the Board of Directors of Talbot Mills was this day held at the office of the Corporation, North Billerica, Mass. at 10 A.M.

* * * * * *

The Treasurer reported that he had seen Parker Wilder's bal- ... Jan. 1, 19... nd that our credit balance was amply protected.

Replacement & Improvement Program

	Total	1942	1943	1944	1945	1946	1947	1948	1949	1950	1951
General											
Bridge	$5,000				5,000						
Picking											
2 Pickers	10,000			10,000							
Carding											
5 Condensers	20,000	12,000	8,000								
Spinning											
24 Frames @ $7,000 (Units of 6)	168,000		42,000		42,000		42,000	42,000			
Winding											
Schweiter Winders	22,000								22,000		
Weaving											
60 W 2 Looms	90,000	18,000		36,000		36,000					
Carbo											
Widen & Speed up New tank & Dryer	20,000	20,000									
Dyeing											
2 Steel Kettles	8,000			4,000	4,000						
Finishing											
Misc.	10,000	1,000	1,000	1,000	1,000	1,000	1,000	1,000	1,000	1,000	1,000
Power											
Boilers	40,000									40,000	
Generators	50,000										50,000
Total	443,000	51,000	51,000	51,000	52,000	37,000	43,000	43,000	23,000	41,000	51,000

The President reported the situation with respect to unfilled orders and raw material commitments.

The President reported on recent installations of machinery, on improvements effected by the organization, and on savings in materials and labor resulting therefrom.

The President presented the attached ten year program for replacement and improvement of machinery and equipment and on Mr. Taylor's motion, seconded by Mr. Eaton it was

Voted:—That the program be adopted in principle.

* * * * * *

On Mr. Eaton's motion, seconded by Mr. Taylor It was

Voted:—That the deferment of the payment of the interest hereinafter specified, upon the registered notes of the corporation, shall hereupon cease, it being hereby determined that the need for such deferment, by reason of the condition of the corporation, has ceased; this vote to apply to one-third of the three-fourths of the interest for and on account of the fiscal year ended September 28, 1940, deferred by vote of the Directors on November 27, 1940.

* * * * * *

Voted to dissolve

A true Record

Attest LINCOLN CLARK Clerk

(EXCERPTS FROM) EXHIBIT 16-P.

September 15, 1941

A meeting of the Board of Directors of Talbot Mills was this day held at the office of the Corporation, North Billerica, Mass. at 3 P.M.

* * * * * *

On Mr. Eaton's motion seconded by Mr. F. S. Clark, Jr., it was

Voted: That the deferment of the payment of the interest hereinafter specified, upon the registered notes of the cor-

poration, shall hereupon cease, it being hereby determined that the need for such deferment, by reason of the condition of the corporation, has ceased; this vote to apply to one half of the interest for and on account of the fiscal year ended September 28, 1940, deferred by vote of the directors on November 27, 1940.

On Mr. Eaton's motion seconded by Mr. Taylor, it was

Voted: That the treasurer of this corporation be and he hereby is authorized and directed to ascertain and fix, as soon after the close of the current fiscal year as possible, as of the close of the current fiscal year, the rate of interest upon the registered notes of this corporation earned and accrued for and on account of the current fiscal year.

* * * * * *

Voted to dissolve
A True Record
Attest LINCOLN CLARK Clerk

(EXCERPTS FROM) EXHIBIT 17-Q.

November 24, 1941

A meeting of the Board of Directors of Talbot Mills was this day held at the office of the Corporation, North Billerica, Mass. at 10 A.M.

* * * * * *

It was reported to the meeting by the treasurer that pursuant to the authority conferred upon him by vote of the board at its meeting of September 15, 1941, he had ascertained and fixed at 10% the rate of interest applicable to the registered notes of this corporation for and on account of the fiscal year ended October 4, 1941, such rate of 10% being a rate less than that computable with reference to the net earnings of said fiscal year under the terms of said notes but being the maximum rate provided by the

terms of said notes. And thereupon, upon motion duly made and seconded it was

Voted: that the determination by the treasurer as aforesaid be and hereby is accepted and approved.

Upon Mr. Taylor's motion duly seconded it was

Voted: to defer, pursuant to the terms of the registered notes due December 1, 1964, of this corporation, the payment of 3/4's of the annual installment of interest, for and on account of the fiscal year ended October 4, 1941, which under the terms of such notes becomes payable (unless deferred) on December 1, 1941, it being hereby determined by the board that such deferment is necessary by reason of the condition of the corporation; and that such deferment shall continue to that date, not later than December 1, 1964, at which, by further vote of the board, it shall be determined that the need therefor has ceased.

* * * * * *

Voted to dissolve.

A true record

Attest LINCOLN CLARK Clerk

PETITIONER'S EXHIBIT 2-B.

Filing District—Massachusetts SN-IT-3

Treasury Department Internal Revenue Service

Office of Internal Revenue Agent in Charge Boston Division

140 Federal Street

Jan 7—1943

Talbot Mills, Faulkner Street, North Billerica, Massachusetts.

Registered Mail

Gentlemen:

You are advised that the determination of your income tax liability for the taxable year(s) ended September 30, 1940 declared value discloses a deficiency of $7,588.69 and that the determination of your excess-profits tax liability for the year(s) mentioned discloses a deficiency of $2,196.12 as shown in the statement attached.

In accordance with the provisions of existing internal revenue laws, notice is hereby given of the deficiencies mentioned.

Within 90 days (not counting Sunday or a legal holiday in the District of Columbia as the 90th day) from the date of the mailing of this letter, you may file a petition with the Tax Court of the United States for a redetermination of the deficiencies.

Should you not desire to file a petition, you are requested to execute the enclosed form and forward it to the Internal Revenue Agent in Charge, Boston, Mass. for the attention of TMK:90-D. The signing and filing of this form will expedite the closing of your return(s) by permitting an early assessment of the deficiencies, and will prevent the accumulation of interest, since the interset period terminates 30 days after filing the form, or on the date assessment is made, whichever is earlier.

Respectfully,

GUY T. HELVERING, Commissioner,

By T. N. Kenefick

Internal Revenue Agent in Charge.

Enclosures: Statement. Form of waiver. TMK:H.L:WM:c.

Boston Division

STATEMENT

Talbot Mills,
Faulkner Street, North Billerica, Massachusetts.

Tax Liability for Taxable Year Ended September 30, 1940.

	Liability	Assessed	Deficiency
Income tax	$37,291.06	$29,702.37	$7,588.69
Declared value excess-profits tax	2,196.12	none	2,196.12
Total	$39,487.18	$29,702.37	$9,784.81

In making this determination of your income tax and declared value excess-profits tax liability, careful consideration has been given to the report of examination dated November 4, 1941; to your protest dated February 19, 1942; to the statements made at the conferences held on August 15, 1942 and December 1, 1942.

If you do not acquiesce in all of the adjustments making up the deficiency indicated, but desire to stop the accumulation of interest on that part of the deficiency resulting from adjustments to which you agree, please fill out the enclosed form of waiver, inserting therein the amount of the deficiency you desire to have assessed at once. The execution of the form for the agreed portion of the deficiency will not deprive you of your right to petition The Tax Court of the United States for a redetermination of the deficiency.

A copy of this letter and statement has been mailed to your representative, Mr. Melville F. Weston, 30 Federal Street, Boston, Massachusetts, in accordance with the authority contained in the power of attorney executed by you and on file with this office.

Adjustments to Net Income
Year ended September 30, 1940

Net income as disclosed by return		$156,328.27
Unallowable deductions and additional income:		
(a) Excessive depreciation disallowed	$2,229.13	
(b) Replacements	767.93	
(c) Interest accrued	3,042.91	
(d) Interest on stockholders notes	40,000.00	46,039.97
Total		$202,368.24
Nontaxable income and additional deductions:		
(e) Adjustment of capital stock tax	$2,882.10	
(g) Adjustment of Massachusetts excise tax	1,021.29	3,903.39
Net income adjusted		$198,464.85
(d) Interest on stockholders notes		$40,000.00

The amount of $40,000.00 deducted as "interest" on line 20, page 1 of your 1940 income and excess-profits tax return has been disallowed for the reason that it does not represent interest within the meaning of Section 23(b) of the Internal Revenue Code, and is not deductible under that section or any other section of the Code.

(EXCERPTS FROM) OFFICIAL REPORT OF PROCEEDINGS BEFORE THE TAX COURT OF THE UNITED STATES

[Filed October 4, 1943.]

[Title omitted.]

Hearing at Boston, Mass. September 21, 1943.

District Court room, Federal Building, Boston, Massachusetts,

September 21, 1943, 3:00 o'clock P.M.

(Met pursuant to notice.)

Before: Honorable C. R. ARUNDELL, Judge.

Appearances:

MELVILLE F. WESTON, Esq., Appearing for Talbot Mills, the Petitioner, 30 Federal Street, Boston, Mass.

M. L. SEARS, Esq., Appearing for the Commissioner of Internal Revenue, the Respondent, 49 Federal Street, Boston, Mass.

PROCEEDINGS.

The Clerk: Docket No. 1066, Talbot Mills.

Mr. Weston: Ready for the petitioner.

Mr. Sears: Ready for the respondent.

* * * * * *

Mr. Weston: I will offer the stipulation; a signed original and a conformed copy which has all the exhibits, letters, annexed; that is, the exhibits presented in duplicate.

* * * * * *

The Court: The stipulation will be received.

Mr. Weston: I imagine, this is a matter so simple that no misunderstanding could arise. But, I would like to ask Mr. Sears to stipulate orally that on pages 9 and 10 [printed page 15], the parentheses which are used to surround certain figures are the equivalent of red ink. In other words, they signify losses.

Mr. Sears: It is so stipulated.

* * * * * *

Mr. Weston: I would like to refer for a moment, Mr. Sears, to the question of any objections to the contents of the stipulation on the score of materiality but, first, I will put in to complete the stipulation the exhibits which it mentions which come in as—this is Exhibit 1-A which is the corporation income and excess profits tax return for Talbot Mills for the fiscal year beginning October 1, 1939 and ended September 30, 1940. The stipulation refers to this and says it will be Exhibit 1-A.

The Court: It will be received.

Mr. Weston: I have also a carbon copy of the deficiency no-

tice; namely, a Treasury letter to Talbot Mills dated January 7, 1943 and this the stipulation says is to be Exhibit 2-B.

The Court: It will be received.

* * * * * *

THOMAS TALBOT CLARK a witness called on behalf of the petitioner, having first been duly sworn, testified as follows:

The Clerk: State your full name and address.

The Witness: Thomas Talbot Clark, 216 Nesmith Street, Lowell, Massachusetts.

Direct Examination by Mr. WESTON.

Q. 1. You are Mr. Thomas Talbot Clark? *A.* Yes.

Q. 2. And you hold what office in the Talbot Mills? *A.* President and treasurer.

Q. 3. And did you hold that office in the year 1939? *A.* Yes, both offices.

Q. 4. And continuously since that time? *A.* Yes.

Q. 5. Are you familiar with the transfers which have occurred in stock and registered notes in the Talbot Mills since 1939? *A.* I have a record of them; not a mental record.

Q. 6. Calling your attention to the fact that at the original exchange of notes for a portion of the stock ratio of one share of stock to each four $100 notes was created so that each of the investors in the corporation held at that time stock and notes in that ratio, Have sales or transfers since occurred, to your knowledge, which have altered the ratio in the case of any investors? *A.* Yes, there has.

Q. 7. Do you have in mind any of these transfers? *A.* I have a record of them if I am allowed to use it.

Q. 8. You may refresh your recollection from anything you have.

* * * * * *

A. On January 18, 1940 there were transferred from the estate of J. T. Taylor four shares of stock to each of three individuals

and 4,800 in notes to a fourth individual and the same—no, on May 28, 1940 there was transferred one share of stock by Sidney Ewart to Talbot Ewart.

Q. 9. And at that time no note was transferred from Sidney Ewart at all? *A.* No. On June 1, 1940 Elizabeth H. Eaton transferred two thousand in notes to F. W. Eaton.

Q. 10. And transferred no stocks? *A.* And no stock.

Q. 11. What is the relationship of F. W. Eaton to Elizabeth H. Eaton? *A.* Brother and sister-in-law.

Q. 12. Brother and sister-in-law; that is, he is the brother of Mrs. Eaton's husband? *A.* He was.

Q. 13. Was? *A.* Yes, I think that is all the transactions.

Q. 14. Of that character? *A.* I think so.

Q. 15. The stipulation contains this statement. "The stock was held on September 30, 1939 by fifteen stockholders who with the exception of one holder of ten shares to qualify as a director were all members of the Talbot family by descent or marriage or were trusts created by such members." Will you state the relationship by blood or marriage which existed between the members of the Talbot family? *A.* What date?

Q. 16. September 30, 1939. *A.* Well, I would have to have a list of the stockholders on that date.

Q. 17. It might be, Mr. Clark, that you would find it easier to state in what generation of the family all those holdings commenced and how the line was branched. *A.* Well, I might say that all of the stockholders were descendants from three brothers or were married to a descendant of the three brothers. Two of those brothers founded the business and a third one had no connection with the business. Well, this is Thomas T. Clark, myself, and I am the second generation from what we may call brother No. 1.

Q. 18. That is, you are a grandson of one of these three brothers? *A.* That's right.

Q. 19. Yes. *A.* Frederick S. Clark, Jr. is the same and is my brother. Lincoln Clark—the same—my brother. Mrs. Elizabeth

H. Eaton—same—my sister. John M. Eaton was Mrs. Eaton's husband. Mrs. Glass Talbot Randell is the same generation and the first cousin.

Q. 20. That is, she is a grandchild of brother No. 2? *A.* No, she is a grandchild of brother No. 1.

Q. 21. But— *A.* Through a different child of No. 1. Darley Randell is her husband. M. A. Taylor trustee for Gertrude T. Taylor, and I presume you want to know about Gertrude?

Q. 22. Yes. *A.* Gertrude Taylor was the granddaughter of brother No. 2 and second cousin of mine. M. A. Taylor was her husband. Mrs. Sidney S. H. Ewart is the wife of another grandson of brother No. 2. Mrs. Harriet T. Parker is a granddaughter of grandfather, brother No. 2. J. Colby Bassett was no relation. Moses G. Parker trust—I don't know what I can say about that.

Q. 23. Well, is that— *A.* (Interposing). To my knowledge—

Q. 24. Well, does that bear approximately the same relationship to the picture as Mrs. Harriet T. Parker? *A.* I presume so. I would say so.

Q. 25. The trust being one of which she is a beneficiary? *A.* Yes, I think so; yes. Mrs. Elizabeth T. Towne is a granddaughter of brother No. 3; unconnected with the business.

Q. 26. Is that the whole list? *A.* Yes, sir.

Q. 27. Is it then fair to say that these members of the Talbot family who are described in the stipulation fall into three groups and each one of these groups is related to each of the other groups as remotely as this, namely, that the grandfather, the grandparent of each one of the three groups was a brother of the grandparent of each other one of the three groups? *A.* That's right.

Q. 28. And no nearer relationship than that between the three groups existed in 1939? *A.* Right.

Q. 29. Where—will you then read—oh, no, this isn't summarized, is it?

Mr. Sears: If I may see this, Mr. Weston, I may be willing that it go in. *A.* They all had a common great grandfather.

Q. 30. Yes, they all had a common great grandfather.

Mr. Sears: Is it as to the application of columns 1, 2 and 3?

Mr. Weston: These are names, addresses and number of shares

Mr. Sears: I have no objection to that going in. It will sav time.

The Court: Yes.

Mr. Sears: You will give me a copy of that, won't you, Mr Weston?

Mr. Weston: Would it not be best if I simply had one of thes made up having this taken for the moment and then having th privilege of substituting a properly prepared one?

The Court: Very well. But, let's get it in and get it marke and you can withdraw it and make a transcript.

The Clerk: Petitioner's Exhibit No. 3.

[Document referred to, received in evidence and marke Petitioner's Exhibit No. 3, of this date.]

Q. 31 (by Mr. Weston). In the stipulation, Mr. Clark, at pag 11, a list of notes is shown. This is paragraph 17. I show yo this list and ask you whether all of these notes were outstandin at one time or whether some were renewals of other notes? *A* They were not all outstanding at one time.

Q. 32. Were many of them renewals? *A.* Many of them wer renewals of other notes.

Q. 33. Can you tell which are the original notes and whic are the renewals? Just a minute.

Mr. Weston: I will save you the trouble of answering tha question, because Mr. Sears is agreeable that I may read into th record the story with respect to these notes.

In the notes payable to the New England Trust Co. which ap pear here were five entries of $50,000 each. There is actually bu a single $50,000 note. Starting with the note dated 7/20/39, th other four entries are renewals of the same note.

In the list of notes payable to the First National Bank of Bosto there are actually two notes and the renewals of those two notes One is the note originally dated 7/12/39 for $35,000 which wa

renewed on January 30, 1940 and again on July 13, 1940 and on the last occasion was increased to $40,000.

The second is a note for $50,000 originally dated October 28, 1939 and renewed on January 18, 1940, April 26, 1940 and July 18, 1940, each time in the same amount of $50,000.

Q. 34. I will ask you, Mr. Clark, whether the $35,000 note to the First National Bank of Boston originally dated July 12, 1939 was secured by a pledge of life insurance in the same manner as the stipulation indicates the renewals of that same note was secured? *A.* Yes, it was.

* * * * * *

Q. 35. Mr. Clark, in one of the directors' meetings of which the Government has asked to have minutes annexed to the stipulation; namely, the meeting of November 27, 1940, this statement appears; "The treasurer reported the ability to pay all bank loans and the arrangement to borrow $400,000 at three per cent." Will you explain what that entry meant? *A.* That meant that we had enough cash and accounts receivables which we could cash at the date of the statement to pay the $100,000, I believe, that was due the banks. At the same time our selling agents Parker, Wilder & Co. were carrying our entire raw material inventory which off-hand I would say was up in the three hundred thousand dollars—but, I am not positive. And they were charging us six per cent for the privilege of carrying it and the purpose of borrowing $400,000 instead of $100,000—it was really an increase—we never paid the $100,000. We raised it from $100,000 to $400,000. The purpose of that was to take over the inventory from Parker, Wilder & Co., borrowing the money at three per cent instead of paying Parker, Wilder six per cent.

Q. 36. Who did you borrow this $400,000 from? *A.* The same banks who had the $100,000.

Q. 37. So, actually although you were able to pay off the $100,000 you owed to banks you were not able at that time to pay off the much larger Parker, Wilder & Co. indebtedness? *A.* That's right.

Q. 38. Unless you borrowed that money? *A.* That's right.

Q. 39. And actually what you did and what this entry referred to was to increase the bank loans to $400,000 and in the process pay off Parker, Wilder & Co.? *A.* That's right.

Q. 40. Is that correct? *A.* That's right.

Q. 41. What was the condition of the Talbot Mills in the years 1937 to 1938; very broadly speaking? *A.* In the financial condition?

Q. 42. Yes. The whole picture of the company. How would you describe it? *A.* Well, in the fall of 1937 it became very apparent that it was anything but competitive and we had lost so much of our liquid resources as we could afford to lose and still stay in business. If we continued losing money at the rate we were losing it at that time. It was very critical and it was a case of doing something radical or liquidate.

Q. 43. Did you present to your stockholders the question whether you should or should not liquidate? *A.* Yes, sir.

Q. 44. What was their decision? *A.* Their decision was to continue in business.

Q. 45. In connection with that decision did you make any statements to your stockholders with respect to what you proposed to do if they would leave you in business? *A.* Plenty.

Q. 46. And broadly speaking, what did you propose to do? *A.* We proposed to run the mill out and discharge everybody on the payroll except the watchman, the fireman and the treasurer. It was then decided to completely rehabilitate the physical plant and to reorganize the personnel; not so much the day workers as the supervisory force, the executive force. It was also suggested that we might improve our situation in regard to state taxes and local taxes. That was done. It was also suggested that we might improve the capital structure of the corporation in the way to make it more attractive to the investors. All of those things were eventually done.

Q. 47. Were those matters discussed at length with your stockholders and directors by the officers? *A.* They were.

Q. 48. And were they then taken and carried through on all fronts to a conclusion? *A.* Oh, I wouldn't say that the conclusion had yet been reached.

Q. 49. But a course of action was embarked on which has lasted to the present time? *A.* That's correct.

Q. 50. And did that course of action include changes in the capital structure, voted at the time of this exchange of notes to stock? *A.* It did; not in detail.

Q. 51. What? *A.* Not in detail.

Q. 52. No, not in detail.

Mr. Weston: Your witness.

Cross Examination by Mr. SEARS.

X-Q. 53. Mr. Clark, in May of 1939 a directors' meeting was held at which it was determined to improve the capital structure with an eye to improving the condition of the company. In what regard do you feel that you improved the condition of the company by the calling in of the stock and the issuance of the notes? *A.* Well, we have lessened equity which enables a concentration of control to effect a stable management.

X-Q. 54. You didn't receive any new capital though, did you? *A.* No, not at that time.

X-Q. 55. There was nothing paid in for these notes, except the turning in of the stock and the reissuance of the notes? *A.* That's all.

X-Q. 56. The instructions were given at the directors' meeting of May 8 to investigate the situation and on September 14, 1939 the so-called plan of reorganization was submitted to the directors, is that correct? *A.* I believe so.

X-Q. 57. Were there any meetings held between those dates? *A.* Not unless they are recorded.

Mr. Sears: Well, I didn't ask you to bring the minute book in, but, are you sure, Mr. Weston, that that is the fact? Do you know whether that's true?

Mr. Weston: No, I don't know whether it was true.

X-Q. 58. You did pay off some machinery notes during the fiscal year ending 1940, did you not? A. If it's in the stipulation, we did. I can't recall.

X-Q. 59. You don't recall paying off $100,000? A. I recall paying it off but not the date.

X-Q. 60. You don't recall the date?

Mr. Sears: I think, that's all I have.

Redirect Examination by Mr. WESTON.

Q. 61. In response to counsel's question, about how the capital structure of the company was improved, you mentioned the fact that reducing of the equity would make it possible for a smaller amount of capital acquiring stock from time to time to bring the control together so that a stable management might be insured. I suppose you had in mind that your family situation might some day call for more concentration in one of the branches? A. Yes, sir.

Q. 62. Than then existed? A. Yes.

Q. 63. Do any other advantages occur to you as having been achieved by the exchange? A. Yes. It enabled the investors to receive certificates of interest or whatever you call it in a form which would be negotiable and enable them to get their money out of the business if they so desire.

Q. 64. That, is— A. (Interposing): Particularly a minority stockholder or a bondholder or whatever it may be who could not otherwise compel liquidation.

Q. 65. That is, a man who as a stockholder and a minority stockholder could never get his money out without the others joining with him? A. That's right.

Q. 66. Now, has a note with a definite maturity and a notice that he can call for his money some day? A. Well, not only that but it's negotiable. He may not have to wait 25 years.

Q. 67. Meanwhile he can sell it? A. It's a sort of investment which has a more or less definite value whereas the stock had a very indefinite value.

Q. 68. In your opinion as a treasurer of your company of your

knowledge of the corporation, are one of these notes a better investment for a man to buy than the stock? *A.* Yes, sir.

* * * * * *

Q. 69. You have mentioned, Mr. Clark, two advantages in the corporate structure that you deemed to have derived from this exchange. One is the reduction of the equity capital so as to render control of the corporation and the stable management more easily obtainable, and the second is to give the investor a security that after at least a certain known length of time, he can cash in if he wants to and which in the meantime he will find in your opinion more saleable than the common stock. Those are two reasons why you think the capital structure was approved; are there any others? *A.* Well, in order to persuade the stockholders that the company should be kept running and not liquidated, it was necessary to offer this among other things—this change in capitalization with its advantages which have been mentioned, among other things, to get their approval of continuing the business.

Q. 70. Was there any advantage from the point—

Examination by the Court:

Q. 71. Now, I don't quite understand that. You get a small group of stockholders. Now, if they weren't operating the business they can say so. If they don't want to they can do it themselves. Well, what do you mean? Do you mean that you can say to the stockholders that we will give you a thousand or so if you will continue? *A.* Well, sir, the stockholders for a while did not want to continue the business and they had to have some bait; they had to have some chance of getting—either getting the money out or getting something that they could sell in order to get their money out.

Q. 72. Well, who gives them the bait? *A.* Well, they give it to themselves. But, somebody had to suggest it to them. They had no ideas of their own and the program had to be presented to the stockholders which had sufficient appeal to entice them into a vote to continue the business.

Q. 73 (by Mr. Weston). And who presented that program? *A.* I presented that program to the directors, and the directors to

the stockholders, and there was sufficient argument about it so that one director resigned because he was not in sympathy with the program. The stock was not sufficient to hold up the program.

Q. 74 (by the Court). Well, the stockholders at the time did not get any advantage in the sense of getting any money out of the business? *A.* No, not at the moment. But, they got a security which was negotiable. Stock in a small closely held corporation —there is no market for them whatever.

Q. 75. Well, why were the notes drawn in this manner? If you want to get negotiability for your stockholders why didn't you give it a negotiable note?

Mr. Weston: If I may interject, sir, isn't that begging the question? When you read the terms of the notes you will find that had a negotiable note. It's registered. It does not in the least impair their general transferability.

* * * * * *

Q. 76. Is it also true, Mr. Clark, that the question or that the fact that interest on these notes would be deductible for Federal tax purposes was taken into account? *A.* It was.

Q. 77. And were the several advantages including that last one that you have mentioned—were they presented to the stockholders and the directors for consideration? *A.* They were.

Q. 78. By whom were they presented? *A.* By myself.

Q. 79. And—on what occasions were they presented? *A.* They were presented to the directors in the fall of 1939—'37.

Q. 80. And were there discussions thereafter? *A.* And to the stockholders following the directors.

Q. 81. And were there discussions then in the years between the commencement of the desired change in 1937 and this final meeting in 1939—were there talks during all that time about what we will do with the company to improve it? *A.* Yes, sir.

Q. 82. And so far as one man can know what goes on in the minds of another, were these the inducements that led the directors and stockholders to act as they did? *A.* You mean everything that I have mentioned?

Q. 83. Yes. *A.* The rehabilitation and the everything all together combination?

Q. 84. And particularly the capital exchange? *A.* Yes, they were.

Q. 85. So far as you know, so far as one man can know about what is in the mind of another, these advantages of all the changes were the inducements to the directors and stockholders to make them—is that correct? *A.* To make the exchange?

Q. 86. To make the exchange. *A.* Yes.

* * * * * *

Recross Examination by Mr. Sears.

X-Q. 87. You mentioned the fact that this recapitalization was considered in 1937? *A.* Not in detail.

X-Q. 88. Not with regard to the exchange in stock and notes? That was discussed in 1939? *A.* But the details were worked out in 1939.

X-Q. 89. You said the details. Had you any discussion as to a change of capital structure in 1937? *A.* Not in detail.

X-Q. 90. What do you mean by detail? *A.* We didn't suggest swapping one for four.

X-Q. 91. You suggested? *A.* No, we didn't.

X-Q. 92. That was a new item in 1939? *A.* Well, it was suggested that some swap might be made but no details were worked out in 1937.

X-Q. 93. What swap could be made? *A.* That we could change our capital structure.

X-Q. 94. To get an interest deduction? *A.* Well, not alone, to get marketability and control.

X-Q. 95. And to guarantee the income to the stockholders? *A.* No guarantee on notes is more than two per cent.

X-Q. 96. Well, to the extent of two per cent then as they would be guaranteed in income whereas a dividend would have to be declared? *A.* No. At that time there was no two per cent and ten per cent was not worked out.

X-Q. 97. But in 1939 it was worked out? *A.* In 1939 it was worked out?

X-Q. 98. And one of the advantages was that the stockholders would obtain a regularity of income? *A.* Yes.

Mr. Weston: I object to the use of the word "stockholders" in just that form. You are obviously asking what the noteholders were to obtain.

Mr. Sears: I am talking about the stockholders. The stockholders are going to receive the notes and the guaranteed income on them, whereas their stock would have not unless declared by the directors. *A.* Well, not in 1937.

X-Q. 99. I am talking about 1939. *A.* 1939? Well, 1939 when the details were all worked out.

X-Q. 100. That's one of the advantages that you offered to the stockholders, is it not true? *A.* That they would get two per cent.

X-Q. 101. As a matter of fact, you know the terms of the note. They didn't even have to get the two per cent, did they? The board of directors could waive that interest. *A.* I don't think so. The two per cent is mandatory.

X-Q. 102. If earned. *A.* No.

X-Q. 103. No? *A.* I think the two per cent is mandatory.

X-Q. 104. But it could be determined not later than 1964?

Mr. Weston: Well, we will leave that for the stipulation.

Mr. Sears: That's all.

Redirect Examination by Mr. WESTON.

Q. 105. You believe it, Mr. Clark, that it is a fact that the recapitalization or that there should be some sort of recapitalization, was mentioned and talked of in 1937? *A.* Right.

Mr. Weston: That's all.

Mr. Sears: The respondent rests.

* * * * * *

3 T. C. No. 11

THE TAX COURT OF THE UNITED STATES.

Talbot Mills, Petitioner,

v.

Commissioner of Internal Revenue, Respondent.

Docket No. 1066. Promulgated January 21, 1944.

Petitioner, a family corporation, in 1939 issued, in exchange for four-fifths of its outstanding capital stock, "registered notes" in face value equal to the par value of the stock surrendered, having a maturity date, and bearing interest at a variable rate from 2 to 10 percent computed with reference to profits. The interest was deferrable in the discretion of the directors, and interest and principal were subject to subordination to outside creditors. *Held*, the security is more in the nature of a capital investment than a loan to the corporation, and payments made as interest are in fact dividends, not deductible from gross income under section 23(b) of the Internal Revenue Code.

MELVILLE F. WESTON, Esq., for the Petitioner.

M. L. SEARS, Esq., for the Respondent.

The Commissioner determined deficiencies of $7,588.69 in corporation income tax and $2,196.12 in declared value excess profits tax for the fiscal year ending September 30, 1940. Certain minor concessions have altered the amounts in controversy to $6,940.15 and $2,415.73, respectively. These deficiencies resulted from a disallowance by the Commissioner of a claimed deduction of $40,000 for interest paid by the petitioner on certain securities issued in exchange for part of its stock. The sole question is whether this amount was properly deductible as interest within the meaning of section 23(b) of the Internal Revenue Code.

FINDINGS OF FACT.

The essential facts, most of which are stipulated and are hereby found accordingly, are as follows:

The petitioner, a Massachusetts corporation with principal offices in North Billerica, filed its return for the fiscal year in question with the collector for the district of Massachusetts. Prior to the transactions out of which arose the present controversy the petitioner had outstanding as its total capital stock 5,000 shares of common stock, par value $100. This stock was held on September 30, 1939 by 15 stockholders who, with the exception of one holder of ten qualifying shares, were all members of the Talbot family by descent or marriage, or were trusts created by such members.

For several years the company had been gradually losing money and in 1937 there was some discussion among the stockholders as to liquidation. However, upon the basis of a proposed renovation of plant and personnel, plus a possible recapitalization, they decided to continue the business. On May 8, 1939, by corporate resolution, the treasurer was authorized "to retain counsel to examine the capital structure of the company with the view to seeing if any modification can be made in same to the advantage of the company." On September 14, 1939, a plan of reorganization was submitted to the directors and adopted by them. The stockholders gave their unanimous approval on September 29, 1939. The tax advantage was one of the motivating facts in the adoption of this plan.

In pursuance of the plan, each holder surrendered 4/5ths of his stock, which was duly retired by the corporation, and the capital stock accordingly reduced. In return for the stock so surrendered the petitioner issued "registered notes", in aggregate face values equal to the aggregate par value of the stock retired. The total amount of the notes issued was thus $400,000.

The notes are voluminous and complex. Maturity is set for December 1, 1964, slightly more than 25 years from the date of

issue. They provide for annual interest payable on December 1 of each year, but payment of interest may be deferred by vote of the board of directors for such time as they "may in good faith determine to be necessary by reason of the condition of the corporation . . . provided that such suspension of payment shall in no wise relieve the corporation of the obligation to pay the amount suspended at some future time and shall in no event operate to defer payment beyond December 1, 1964.".

The rate of interest was provided as follows: "Interest hereon shall be payable annually . . . at a rate which shall not exceed 10 per cent nor be less than 2 per cent and, subject to these limitations, shall be a rate computed as follows:—There shall be taken a sum equal to two-thirds (2/3ds) of the net earnings of the corporation for the fiscal year ended last previous to such December 1, computed in accordance with the regular bookkeeping methods and practices of the corporation as established from time to time in good faith by its directors and officers but without deduction for federal income taxes paid or accrued and without deduction for interest upon these notes, and the rate of interest shall be the rate, figured to the nearest one-quarter (1/4%) which such sum would represent as interest upon an assumed principal sum of Four Hundred Thousand ($400,000) Dollars. Provided, nevertheless, that from and after the close of the fiscal year ended next previous to December 1, 1964, and for such further time as this note shall remain unpaid, interest shall be at the rate of six per cent (6%) per annum, and such interest to December 1, 1964 shall be included in the installment payable at that date."

The notes further provided that no dividends were to be paid on any shares of stock until all then due interest on the notes was satisfied. In the event of bankruptcy, receivership, dissolution, or liquidation, the principal and interest were to become immediately due, with interest at the rate of six per cent from the close of the preceding fiscal year.

No mortgage of the real estate of the corporation or of its machinery or equipment to secure an obligation maturing after

December 1, 1964, other than a purchase money mortgage, could be made while the notes were outstanding without the consent of the holders of 3/5ths in interest of the notes. Power to subordinate to any obligation maturing not later than December 1, 1964 was vested in the directors, such subordination to impose upon the holders no personal liability other than a liability to deliver to the unsatisfied creditors any sums or securities paid to the holder in connection with any reorganization, or in any substitution of the notes. The corporation might at any time pay and retire the notes at par plus accrued interest, except as otherwise provided in any subordination agreement. There then followed this provision:

> . . . With the written consent of the corporation and of the holders of three-fifths (3/5ths) in amount of the total amount of these notes at the time outstanding, filed with the corporation, any of the terms and provisions of this series of notes may be altered or amended so as to bind the corporation and every holder, whether consenting or not, provided that no such change shall:—(a) extend the date for the maturity of the principal of the notes; (b) alter the rate of interest or the method of computing the rate of interest, except in so far as required for an adjustment to a changed fiscal year as above; (c) diminish the principal amount payable at maturity or the amount to be paid upon any earlier payment as above provided; or (d) vacate or diminish the effect of any subordination previously voted and in force.

The notes were transferable by endorsement on an attached form, which was required to be authenticated by the clerk of the corporation. In the following years some few notes totaling $6,800 were transferred, but always within the close family circle.

Shortly after the adoption of this plan, the notes were subordinated, by vote of the board of directors, to three loans. Two banks to which the taxpayer was indebted in the amount of $100,000 required, as a condition of their forbearing to demand payment, the execution of a formal agreement of subordination as to

both principal and interest. On October 10, 1939 the subordination was voted, and on the same date the required agreement was executed. This agreement covered all existing and future indebtedness, and provided that:

> So long as any part of the Bank Indebtedness shall remain unsatisfied, the Noteholders will not, without the prior written consent of each of the Banks, demand, accept or receive from the Mills any payment of principal of or interest on or any collateral or other security for the Notes held by them respectively, or any other notes or obligations in renewal of or in substitution therefor, except, pursuant to the exchange provisions contained in the Notes, another Note of the same tenor, and the Mills will not, without such written consent, pay any amount on account of the principal of or interest on, or give any collateral or other security for, any of the Notes, or give any other Notes or obligations in renewal thereof or in substitution therefor, except as aforesaid, to any Noteholders.
>
> In the event of any petition in bankruptcy being brought by or against the Mills, and in the event of any other proceedings for the liquidation of the Mills, either by its voluntary action or otherwise, the Noteholders will assign and pay over to the Banks, ratably in proportion to the amount of the Bank Indebtedness owed to them respectively, to the extent necessary to satisfy the Bank Indebtedness in full, any and all distributions and payments in respect of the Notes to which the Noteholders would be entitled in any such proceedings.

This agreement further provided that in the event of any reorganization or composition, any payment to the noteholders should be paid over to the banks, to be applied to the indebtedness; and any securities or property so delivered to the banks to be held by them subject to the subordination. No personal liability other than the above was imposed on the noteholders.

On the same date the notes were also subordinated, as to principal and interest, to a $100,000 machinery loan, and to a further

$30,000 indebtedness to one of the banks. All of these subordinations have since been terminated by payment of the obligations.

On November 27, 1940, the petitioner's treasurer reported that:

> . . . he had ascertained and fixed at 10 per cent the rate of interest applicable to the registered notes of this Corporation for and on account of the fiscal year ended September 28, 1940, such rate of 10 per cent being a rate less than that computable with reference to the net earnings of said fiscal year under the terms of said notes and being the maximum rate provided by the terms of said notes.

The report was forthwith accepted and approved. The directors then voted to defer the payment of three-fourths of the interest which would otherwise be payable on December 1, 1940. On March 25, 1941, this deferment was partially terminated, and on September 15, 1941 wholly terminated, so that in three installments over the course of the fiscal year the total of $40,000 was disbursed. It is the deduction of this amount which the respondent contests.

Opinion.

Arundell, Judge: The facts presented raise the narrow question as to whether or not the acts of the taxpayer have been sufficient to give rise to an indebtedness within the ambit of section 23(b) of the Internal Revenue Code. If so, then the payments made as interest are deductible as such; if not, then they must be considered in fact dividends, hence not deductible.

Precedent provides no ready test. The question is factual, and no one factor may be said to be controlling. *Commissioner* v. *Schmoll Fils Associated, Inc.*, 110 Fed. (2d) 611. "The determining factors are usually listed as the name given to the certificates, the presence or absence of maturity date, the source of the payments, the right to enforce the payment of principal and interest, participation in management, status equal to or inferior to that of regular corporate creditors, and intent of the parties." *John Kelley Co.*, 1 T.C. 457.

Numerous cases are cited by petitioner which bear upon, but

do not decide the question. Especially relied upon is *Commissioner* v. *O. P. P. Holding Corp.*, 76 Fed. (2d) 11. In that case a corporation, in part payment of the entire capital stock of another corporation, issued debenture bonds maturing in 25 years, unless extended by a 2/3rds vote of the holders, bearing interest at eight per cent with provisions for the subordination of principal and deferment of interest. The deferment was not, however, to relieve the corporation of the ultimate obligation to pay. The securities were held to evidence an indebtedness, and payments made as interest thereon were properly deductible. But these securities lacked the variable rate of interest computed with reference to profits that is a prominent feature of the present notes; and, further, they were not, as here, issued in exchange for stock of the issuing corporation.

In *John Kelley Co., supra,* there was present the exchange feature. There the petitioner, a closely held corporation, issued maturing, eight per cent "income debenture bonds" in exchange for outstanding preferred stock, the excess after exchanges to be sold at face value to the shareholders. The interest was to be paid "out of income", and there was provision for suit for enforcing payment of principal and interest in case of default. This court held that the transaction gave rise to a valid indebtedness, and the deduction of interest payments was allowed. Here again there are distinctions. In *John Kelley Co., supra,* there was a flat rate of interest, though payable out of income, as contrasted with the variable, profit-determined rate of the Talbot notes; the interest payments were due whenever the net income was sufficient, with provision for suit in case of default in punctual payment, whereas in the instant case the payment of interest might be deferred, though the net income was sufficient, for such time as the directors might see fit; and debentures remaining after the exchange were issued on subscription to the stockholders, whereas this transaction was exclusively an exchange.

In *Kena, Inc.*, 44 B.T.A. 217, a substantially similar interest provision was considered, and this court, holding for the taxpayer,

said: "It is not essential that interest be computed at a stated rate, but only that a sum definitely ascertainable shall be paid for the use of borrowed money, pursuant to the agreement of the lender and the borrower." Nor is the deferability of interest payments at the option of the corporation fatal, standing alone. *Commissioner* v. *O. P. P. Holding Co., supra.*

It is the cumulation of these various restrictive features that tends to cast doubt on the real nature of the instant transaction. In this state of affairs reference must be had to the circumstances surrounding the issuance, to determine the intent of the parties, See *Commissioner* v. *Proctor Shop, Inc.*, 82 Fed. (2d) 792, where it is stated, in the words of the United States Board of Tax Appeals. "In each case it must be determined whether the real transaction was that of an investment in the corporation or a loan to it. . . . The real intention of the parties is to be sought and in order to establish it evidence *aliunde* the contract is admissible."

The factor of tax avoidance loomed large in the minds of the parties by their own admission, and indeed appears to have been the only substantial purpose motivating the transaction. It was stated in testimony that there were also the advantages of a reduction in equity control, enabling a concentration of control to effect a stable management, and the providing of a form of investment which would be negotiable, and more readily saleable. As to the first, it is difficult to see how a pro rata reduction of capital stock would facilitate concentrated control, nor did it in fact change the control. Each shareholder retained the precise voice in the management which he had prior to the transaction. He retained the same right to participate in the profits of the business; what he did not receive by way of interest he would take by way of dividends on his remaining stock. As to negotiability, only a very slight fraction of the notes has actually been severed from stockholdings, and this all within the close family circle. It is questionable how much more saleable than the original stock the restricted, subordinated, deferable notes would have been.

In the light of these facts, it appears that what the parties really

intended to create was a security retaining the profit-sharing advantage of stock, leaving intact their voice in the management, but extending a tax advantage to the corporation not possible in stock. This would seem to create no proper indebtedness. This being so, the 2 per cent minimum provision of the note will stand upon no better footing than the whole.

In view of the foregoing, it is our conclusion that the "registered notes" were more in the nature of a capital investment than a loan to the corporation, and payments made as "interest" are not deductible under section 23(b) of the Internal Revenue Code.

Decision will be entered under Rule 50.

[Title omitted.]

RESPONDENT'S COMPUTATION FOR ENTRY OF DECISION.

[Filed February 9, 1944.]

The attached proposed computation is submitted, on behalf of the respondent, to The Tax Court of the United States in compliance with its opinion determining the issues in this proceeding.

This computation is submitted in accordance with the opinion of the Tax Court, without prejudice to the right of either party to contest the correctness of the decision entered herein by the Tax Court, pursuant to the statute in such cases made and provided.

J. P. WENCHEL,
Chief Counsel, Bureau of Internal Revenue.

Of Counsel:

CHARLES P. REILLY,
Division Counsel, Bureau of Internal Revenue.

Petitioner is in agreement with respondent's computation.

MELVILLE F. WESTON,
Counsel for Petitioner.

hd 2-3-44

C-TS:NED GB:*Re* computation

February 3, 1944.

AUDIT STATEMENT

In re: Talbot Mills, Faulkner Street, North Billerica, Mass.

Docket No. 1066

Fiscal year ended September 30, 1940

Declared Value Excess Profits Tax

Liability	Assessed	Deficiency in Assessment
$2,415.73	None	$2,415.73
Liability	**Paid**	**Deficiency in Payment**
$2,415.73	None	$2,415.73

Income Tax

Liability	Assessed	Deficiency in Assessment
$37,249.33	$30,309.18	$6,940.15
Liability	**Paid**	**Deficiency in Payment**
$37,249.33	$30,309.18	$6,940.15

Computation of tax liability in accordance with the opinion of the Tax Court of the United States entered January 25, 1944.

Talbot Mills Fiscal Year ended September 30, 1940.

Schedule 1 Net Income

Net income deficiency notice dated January 7, 1943	$198,464.85
Adjustment	None
Net income adjusted	$198,464.85

The stipulation of facts filed with the Tax Court of the United States on page 3, paragraph IV indicates that all adjustments to net income made in the deficiency notice were accepted by the petitioner with the exception of the disallowance of the deduction of $40,000.00 as "interest" on "certain notes".

The opinion of the Tax Court sustains the disallowance of the item protested and recommends no change in the net income computed in the deficiency notice.

Schedule 2 Computation of Tax

Declared Value Excess-Profits Tax

Taxable net income, Schedule 1			$198,464.85
Less: Dividends received credit		None	
Value of capital stock as declared in capital stock tax return for year ended 6/30/40	$1,591,655.98		
Adjustment to net income for fiscal year ended 9/30/39 (Revenue agent's report dated March 25, 1941.)	26,971.96		
Adjusted value of capital stock	$1,618,627.94		
10% of $1,618,627.94		$161,862.79	$161,862.79
Net income subject to declared value excess-profits tax			$36,602.06
Amount taxable at 6%			36,602.06
Excess-profits tax at 6% (as shown in deficiency notice)			2,196.12
Defense tax, 10% of $2,196.12 (erroneously omitted in deficiency notice)			219.61
Total declared value excess-profits and declared value excess-profits defense tax			$2,415.73
Declared value excess-profits and declared value excess-profits defense tax assessed December, 1940, Account $400,030			None
Deficiency in assessment of declared value excess-profits tax and defense tax (page 3, Stipulation of Facts)			$2,415.73
Declared value excess-profits and defense tax liability			$2,415.73

Declared value excess-profits and defense tax paid	None
Deficiency in payment of declared value excess-profits and defense tax	$2,415.73
Income Tax	
Net income, schedule 1	$198,464.85
Less:	
Declared value excess-profits and excess-profits defense taxes	2,415.73
Adjusted net income	$196,049.12
Income tax under General Rule	
19% of $196,049.12	$37,249.33
Income tax assessed December 1940, Supplemental Account No. 400030	29,702.37
Deficiency in assessment (Page 3, Stipulation of Facts)	$7,546.96
Additional assessed July 1943, Account No. 529002	606.81
Deficiency to be assessed (Amount in controversy)	$6,940.15
Income tax liability	$37,249.33
Income tax paid:	
December 17, 1940 $7,425.60	
April 5, 1941 7,425.60	
June 20, 1941 7,425.60	
September 17, 1941 7,425.57	
July 24, 1943 606.81	$30,309.18
Deficiency in payment	$6,940.15

C-TS:NED GB

STATEMENT OF ACCOUNT

In re: Talbot Mills, Faulkner Street, North Billerica, Mass.

Docket No. 1066

Fiscal Year ended September 30, 1940

Declared Value Excess Profits and Defense Tax Liability	$2,415.73

Assessed December 1940, Supplemental Account No. 400030			None
Deficiency in assessment			$2,415.73
Liability			$2,415.73
Paid			None
Deficiency in payment			$2,415.73
Income Tax			
Liability			$37,249.33
Assessed December 1940, Supplemental Account No. 400030		$29,702.37	
Assessed July 1943 Account No. 529002		606.81	30,309.18
Deficiency in assessment			$6,940.15
Liability			$37,249.33
Paid:	December 17, 1940	$7,425.60	
	April 5, 1941	7,425.60	
	June 20, 1941	7,425.60	
	September 17, 1941	7,425.57	
	July 24, 1943	606.81	30,309.18
Deficiency in payment			$6,940.15

GB/mgw

[Title omitted.]

DECISION.

Entered February 12, 1944.

Pursuant to the findings of fact and opinion promulgated January 21, 1944, the respondent herein having on February 9, 1944, filed a recomputation and the petitioner having agreed thereto, now therefore, it is

Ordered and decided: That there are deficiencies in declared value excess profits tax and income tax for the fiscal year ended September 30, 1940 in the respective amounts of $2,415.73 and $6,940.15.

Enter: C. R. ARUNDELL, *Judge.*

[Title omitted.]

PETITION FOR REVIEW.

[Filed May 2, 1944.]

The above-named Talbot Mills hereby petitions for review, by the United States Circuit Court of Appeals for the First Circuit, of the decision of the Tax Court of the United States rendered upon its petition in the cause numbered in the docket of said Tax Court of the United States as above; and in support of this its said petition for review avers as follows:

1. The controversy in the above-entitled cause relates to the federal income and declared value excess profits taxes of the petitioner for its fiscal year ended September 30, 1940. The petitioner claims to be entitled to deduct, in computing its taxable income for such fiscal year, certain sums accrued during that year as interest upon its outstanding registered notes. The Commissioner of Internal Revenue has denied such deduction and has asserted, and said Tax Court of the United States has now by its decision rendered February 12, 1944 affirmed, deficiencies for the said year as follows: Declared value excess profits tax $2,415.73, income tax $6,940.15; which decision your petitioner asserts to be erroneous.

2. The petitioner is Talbot Mills, a Massachusetts corporation with a principal office at Faulkner Street, North Billerica, Massachusetts. It is the only taxpayer involved in the above-entitled cause and is the sole petitioner for review herein.

3. The petitioner's income and declared value excess profits tax return for its said fiscal year ended September 30, 1940 was duly filed in the office of collector of internal revenue for the District of Massachusetts at Boston, Massachusetts, and said decision of the Tax Court of the United States is therefor reviewable by the United States Circuit Court of Appeals for the First Circuit.

Wherefore the petitioner prays that the said decision of the Tax Court of the United States may be reviewed by the said

United States Circuit Court of Appeals for the First Circuit and be reversed and the said deficiencies disallowed.

TALBOT MILLS,
by MELVILLE F. WESTON,
its Attorney of Record.

[Title omitted.]

NOTICE OF FILING PETITION FOR REVIEW.

[Filed May 3, 1944.]

To J. P. WENCHEL, *Chief Counsel, Bureau of Internal Revenue:*

You are hereby notified that Talbot Mills did, on the second day of May, 1944, file with the clerk of The Tax Court of the United States, at Washington, D. C., a petition for review by the United States Circuit Court of Appeals for the First Circuit, of the decision of this court heretofore rendered in the above-entitled case. Copy of the petition for review as filed is hereto attached and served upon you.

Dated this third day of May, 1944.

B. D. GAMBLE, *Clerk,*
The Tax Court of the United States.

Service of copy of petition for review acknowledged this May 4, 1944.

J. P. WENCHEL, SLY,
Chief Counsel, Bureau of Internal Revenue,
Attorney for Respondent.

[Title omitted.]

PETITIONER'S DESIGNATION WITH RESPECT TO CONTENTS OF RECORD UPON PETITION FOR REVIEW.

[Filed May 2, 1944.]

Now comes the petitioner in the above-entitled cause, now petitioner for review herein, and hereby designates as the portions of the record, proceedings, and evidence to be included in the record upon review of the above-entitled cause the following:

1. The petitioner's petition for redetermination of the deficiencies, on file herein; omitting, however, the exhibits annexed to said petition, namely, Exhibit A (the deficiency letter) inasmuch as the same subsequently appears in evidence as Exhibit 2-B, Exhibit A-1 (report of Revenue Agent) since the same was excluded from the evidence upon the trial of the cause, and Exhibit B (the form of registered note) since the same subsequently appears in evidence as Exhibit 4-D.

2. The amended answer of the Commissioner of Internal Revenue, on file herein; omitting, however, the revised audit statement thereto annexed, since all matters relating to the amount in controversy are subsequently disposed of by the stipulation of facts and the agreed recomputation.

3. The stipulation of facts on file herein, together with the exhibits thereto annexed; omitting, however, the portions, enumerated in Schedule A hereto attached, of certain of said exhibits, not material to the determination of the cause and in no wise adverted to by the Tax Court in its findings of fact and opinion.

4. The following portions of Exhibit 1-A (the return, incorporated by reference in, but not annexed to, the stipulation of facts), namely: the Adjusted Net Income Computation and Total Income and Excess-Profits Taxes, as shown on page 1 of the return, *i.e.*, those items on that page numbered 1 through 37, with headings; Schedule A—Excess-Profits Tax Computation—on page 2 of the

return, *i.e.*, lines numbered 1 through 8 on that page; Schedule B —Income Tax Computation—on page 2 of return, so far as relevant, *i.e.*, lines numbered 16 through 20, with headings, and line numbered 54; that portion of Schedule O—Balance Sheets—on page 5 of the return, which deals with liabilities, *i.e.*, lines numbered 9 through 17 of Schedule O, with headings.

5. Exhibit 2-B (the deficiency letter, incorporated by reference in, but not annexed to, the stipulation of facts) omitting therefrom those portions thereof, found under the heading "Explanation of Adjustments" which deal with (a) excessive depreciation disallowed, (b) cost of replacing roof on repair shop, (c) interest accrued, (e) adjustment of capital stock tax (f) adjustment of Massachusetts excise tax.

6. The transcript of testimony herein as stenographically reported; omitting, however, the opening statements and colloquies, constituting no part of the evidence, enumerated in Schedule B hereto attached.

7. The findings of fact and opinion of the Tax Court promulgated January 21, 1944.

8. The recomputation of deficiencies, filed herein.

9 The decision rendered and entered February 12, 1944.

10. Appropriate indications of each mission directed herein.

11. This designation; omitting, however, Schedules A and B hereto attached.

MELVILLE F. WESTON,
Counsel for Petitioner.

[Title omitted.]

PETITIONER'S AMENDMENT TO DESIGNATION.

[Filed May 17, 1944.]

Now comes the petitioner in the above-entitled cause, now petitioner for review herein, and hereby amends its designation, hereinbefore filed, and designates, to be included in the record upon

review in the above-entitled cause, the following further portions of the record, proceedings and evidence:

1. The docket entries of the Tax Court.

2. The petition for review, of the decision of the Tax Court, by the United States Circuit Court of Appeals for the First Circuit.

3. This amendment to designation.

MELVILLE F. WESTON,
Counsel for Petitioner.

[Title omitted.]

CERTIFICATE.

I, B. D. Gamble, clerk of The Tax Court of the United States do hereby certify that the foregoing typewritten pages, 1 to 139 [printed pages 1 to 90], inclusive, contain and are a true copy of the transcript of record, papers, and proceedings on file and of record in my office as called for by the praecipe in the appeal (or appeals) as above numbered and entitled.

In testimony whereof, I hereunto set my hand and affix the seal of The Tax Court of the United States, at Washington, in the District of Columbia, this fifteenth day of June, 1944.

B. D. GAMBLE,
[SEAL] *Clerk, The Tax Court of the United States.*

[MEMORANDUM. An order of enlargement of time for docketing case to, and including, July 31, 1944, is here omitted. A. I. CHARRON, *Clerk.*]

PETITIONER'S STATEMENT OF POINTS TO BE RELIED UPON.

[Filed in Circuit Court of Appeals June 27, 1944.]

Pursuant to the requirements of Paragraph 7 of Rule 22 of this court, the petitioner states the points to be relied upon, upon review of the above-entitled cause in this court, as follows:

I. I.R.C. § 23 (b) expressly makes all interest on indebtedness deductible—not just some interest or interest on just some types of indebtedness.

The Tax Court erred in applying in effect a rule that under certain circumstances—nowhere referred to in the statute—interest on indebtedness is not deductible.

II. The words "indebtedness" and "interest" were used in the statute in their common and ordinary meaning, as well established in general law.

The Tax Court erred in applying to the petitioner's registered notes criteria at variance with the above principle, including the application of an untenable distinction between "loans" and "capital investments".

III. The petitioner's registered notes were evidences of indebtedness, within such common and ordinary meaning, and the annual sums accrued thereon, as the consideration for the principal not being paid until maturity, were interest and deductible as such.

The Tax Court erred in construing petitioner's registered notes as not constituting evidences of indebtedness.

The Tax Court erred in holding the annual sum accrued upon petitioner's registered notes not to be interest.

The Tax Court erred in using extrinsic evidence to control the meaning of an unambiguous written instrument.

The Tax Court erred in holding that the annual sum accrued as interest upon petitioner's registered notes was not deductible as such.

IV. To hold otherwise, merely upon the basis of certain facts found by the Tax Court, would establish a rule conducive to complicated and repetitive investigations, would render unpredictable the application of § 23 (b) in ordinary commercial affairs, would result in inconsistencies in the application of the term "interest"

in other branches of the tax law, and would amount to judicial legislation.

The Tax Court erred in applying to the construction of the statute principles at variance with the above.

V. The Tax Court did not apply the correct rule of law and its decision is not entitled to finality under the *Dobson* case.

TALBOT MILLS,
Petitioner for Review,
by MELVILLE F. WESTON, *Counsel.*

[fol. 93] On November 8, 1944, this cause came on to be heard, and was fully heard by the Court, Honorable Calvert Magruder, Honorable John C. Mahoney, and Honorable Peter Woodbury, Circuit Judges, sitting.

Thereafter, to wit, on December 22, 1944, the following opinion of the Court and Dissenting Opinion were filed:

UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIRST CIRCUIT, OCTOBER TERM, 1944

No. 4015

TALBOT MILLS, Petitioner, for Review,

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent

Petition for Review of Decision of the Tax Court of the United States

Before Magruder, Mahoney and Woodbury, JJ.

Melville F. Weston, Powers & Hall, for Petitioner.

Samuel O. Clark, Jr., Assistant Attorney General; Sewall Key, J. Louis Monarch, Harry Baum, John F. Costelloe, Special Assistants to the Attorney Geenral; J. P. Wenchel, Chief Counsel; Charles E. Lowery, Special Attorney, Bureau of Internal Revenue, for Respondent.

OPINION OF THE COURT—December 22, 1944

MAHONEY, J.:

In its income and excess profits tax returns for the fiscal year ending September 30, 1940, the taxpayer, Talbot Mills, deducted the sum of $40,000 accrued as interest upon certain "registered notes." The Commissioner of Internal Revenue disallowed the deduction on the ground that it did [fol. 94] not represent interest within the meaning of § 23(b) of the Revenue Act of 1938 (52 Stat. 447, 26 U. S. C. A. Internal Revenue Act, p. 1012). The Tax Court of the United States sustained the determination of the Commissioner and concluded "that the 'registered notes' were more in the nature of a capital investment than a loan to the

corporation and payments made as 'interest' are not deductible." The petition for review presents the question whether the payments were dividends or interest.

The taxpayer is a Massachusetts corporation engaged in the manufacture of woven woolen and worsted fabrics. It keeps its books and files its tax returns on the accrual basis. Prior to the beginning of its fiscal year ending September 30, 1940, the taxpayer had outstanding 5,000 shares of $100 par common stock, or a total capital stock of $500,000, and a surplus appearing on its books of $472,754.18. The stock was held by fifteen stockholders who, with the exception of one holder of ten shares to qualify as a director, were either members of the Talbot family, or trusts created by such members. For several years prior to 1937 the taxpayer had been operating at a loss, and in that year the question of liquidation was up for discussion among the stockholders. They decided to stay in business and to take steps towards improving their "competitive condition" such as renovation of the plant and a drastic reorganization of personnel. The possibility of recapitalization was also discussed at that time, and in 1939 the treasurer was authorized "to retain counsel to examine the capital structure of the company with the view to seeing if any modification can be made in same to the advantage of the company." In September of that year a plan of reorganization was submitted to and adopted by the directors, and on September 29, 1939, it was adopted unanimously by the stockholders. Under the plan each stockholder was to surrender four-fifths of his stock in exchange for "registered notes" of a face amount equal to the par value of the stock [fol. 95] surrendered. Pursuant thereto the fifteen stockholders turned in $400,000 of the outstanding $100 par value capital stock, and each received in exchange a share of the $400,000 in notes proportionate to the amount of stock he turned in.

The notes are dated October 2, 1939, and mature December 1, 1964. They provide for interest at an annual rate, ranging from a minimum of 2% to a maximum of 10%, dependent upon the taxpayer's annual earnings.[1] Interest is

[1] "Interest hereon shall be payable annually on December 1 of each year for and on account of the fiscal year of the corporation ended last previous to such December 1, the first such date for the payment of interest being December

[fol. 96] payable December 1 of each year. Payment may be deferred, however, by the directors when the condition of the company warrants such action. No dividends are to be paid on the stock while interest due on the notes remains unpaid. In the event of bankruptcy, receivership, disolution or liquidation, principal and interest are to become immediately due with interest at 6% from the close of the preceding fiscal year. The directors, however, may subordinate the notes "as to both principal and interest

---

1, 1940 at a rate which shall not exceed 10 per cent nor be less than 2 per cent and, subject to these limitations, shall be a rate computed as follows: There shall be taken a sum equal to two-thirds (⅔rds) of the net earnings of the corporation for the fiscal year ended last previous to such December 1, computed in accordance with the regular bookkeeping methods and practices of the corporation as established from time to time in good faith by its directors and officers but without deduction for federal income taxes paid or accrued and without deduction for interest upon these notes, and the rate of interest shall be the rate, figured to the nearest one-quarter per cent (¼%) which such sums would represent as interest upon an assumed principal sum of Four Hundred Thousand ($400,000) Dollars. Provided, nevertheless, that from and after the close of the fiscal year ended next previous to December 1, 1964, and for such further time as this note shall remain unpaid, interest shall be at the rate of six per cent (6%) per annum, and such interest to December 1, 1964, shall be included in the installment payable at that date.

The corporation shall have the power, by vote of its Board of Directors, to defer the payment of all or part of any annual installment of interest for such time as the directors may in good faith determine to be necessary by reason of the condition of the corporation, without incurring liability for interest upon such deferred installment of interest, provided that such suspension of payment shall in no wise relieve the corporation of the obligation to pay the amount suspended at some future time and shall in no event operate to defer payment beyond December 1, 1964. The corporation covenants that it will pay no dividends upon any shares of stock of the corporation unless and until all then due interest upon these notes, including interest which may have been postponed as aforesaid, shall have been paid in full."

to any other indebtedness of the corporation maturing not later than December 1, 1964." The corporation may retire the notes at par plus accrued interest at any time unless otherwise provided in any subordination agreement. No mortgage to secure any obligation maturing after December 1, 1964, other than a purchase money mortgage, may be made while the notes are outstanding without the consent of the holders of three-fifths in amount of the notes. With the consent of the holders of three-fifths in amount, the corporation may alter any of the terms of the notes; provided that no such change shall extend the maturity date for the principal, alter the rate or method of computing the rate of interest, or effect any existing subordination agreement. The notes are transferable by endorsement, and some $6,800 of them have changed hands, all transfers, however, being within the close family circle.

At meetings of the board of directors on October 10, 1939, and November 27, 1939, shortly after the plan had gone into effect, the "registered notes" were subordinated to two loans from one bank of $50,000 bearing interest at 4% and $30,000 bearing interest at 3%, a loan of $50,000 bearing interest at 4% from a second bank, and a loan of $100,000 bearing interest at 6% from a third creditor.

On November 27, 1940, the taxpayer's treasurer reported to the directors that he had fixed at 10% the rate of interest for the fiscal year ending September 28, 1940, a rate less [fol. 97] than that computable with reference to the net earnings under the terms of the notes but being the maximum there provided.

The question resolves itself into what is the proper characterization of the payments. Are they interest and as such deductible under § 23(b),[2] or are they dividends[3] and as

---

[2] 26 U. S. C. § 23.

"In computing net income there shall be allowed as deductions:

(b) *Interest.*—All interest paid or accrued within the taxable year on indebtedness."

[3] § 115.

"(a) *Definition of Dividend.*—The term 'dividend' . . . means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year."

such not deductible? So-called interest, here paid to the stockholders who are also the holders of the "registered notes," may be essentially dividends and not interest if it is regarded as the further distribution of profits. We must also consider the character of the security under which payment is made. Modern corporate practice evidences many departures from the older concepts and forms, and the modern use of many hybrid types of security has been accompanied by an increasingly loose use of terminology in the characterization of the particular security. Conditioned by one set of factors preferred stock may go by the name of bonds and notes, and in other circumstances we may encounter notes and bonds going by the name of preferred stock. Whatever the circumstances the basic question whether the payees are creditors or stockholders, and whether the payments are interest or dividends turns on the consideration of all the relevant facts. *Commissioner* v. *Meridian & Thirteenth Realty Co.*, 132 F. (2d) 182 (C. C. A. 7th, 1942); *Eastern Gas & Fuel Associates* v. *Commissioner*, 128 F. (2d) 369 (C. C. A. 1st, 1942); *Commis-*
[fol. 98] *sioner* v. *Schmoll Fils Associated, Inc.*, 110 F. (2d) 611 (C. C. A. 2nd, 1940); *Commissioner* v. *Proctor Shop, Inc.*, 82 F. (2d) 792 (C. C. A. 9th, 1936); Mertens, *Law of Federal Income Taxation*, sections 9:24 and 26:10.

In the *Proctor Shop* case, *supra*, the court observed that "none of the decided cases lay down any comprehensive rule by which the question presented may be decided in all cases, and 'the decision in each case turns upon the facts of that case,' * * * In each case it must be determined whether the real transaction was that of an investment in the corporation or a loan to it. * * * The real intention of the parties is to be sought and in order to establish it evidence aliunde the contract is admissible." The taxpayer in the instant case is a small "family corporation" with fifteen stockholders. The issuance of the notes brought no new capital into the corporation. They represent a mere exchange of stock for notes which did not affect in any material way the previously existing interest of the stockholders. Each retained the same proportionate right to participate in the profits of the business. The subordinable notes bore a variable rate of interest dependent on earnings, and what each stockholder might not get as "interest" he gets as dividends. The stockholders, moreover, retain their same proportionate control of the corporation as owners.

The taxpayer admits that tax avoidance was an important factor in this exchange, and the Tax Court found that it was "the only substantial purpose motivating the transaction." The taxpayer contended that there were further advantages, the reduction in equity control which enabled a concentration of control to affect stable management, and the providing of an investment, negotiable and more readily saleable than the stock of this closely held corporation. The Tax Court dismissed the first, saying that "each shareholder retained the same precise voice in the management he had before the transaction." As for the negotiability [fol. 99] feature, the notes could be subordinated to creditor claims and were. They contain restrictive provisions, and the payment of interest may be deferred. The rate of return is indeterminate. The few notes negotiated remained in the family circle, and the Tax Court has questioned their saleability. We think that the Tax Court properly found "that what the parties really intended to create was a security retaining the profit-sharing advantage of stock, leaving intact their voice in the management, but extending a tax advantage to the corporation not possible in stock," and that there was no proper indebtedness. To hold the contrary would be exalting form above substance.

The taxpayer contends that the language quoted from the *Proctor Shop* case, *supra*, with respect to "evidence aliunde the contract" has been "misused." He concedes that such use was proper in *Arthur R. Jones Syndicate* v. *Commissioner*, 23 F. (2d) 833 (C. C. A. 7th, 1927), where a stock device was used to conceal a usurious loan and "dividends" paid on such stock were held deductible interest; and in *Wiggin Terminals, Inc.* v. *Commissioner*, 36 F. (2d) 893 (C. C. A. 1st, 1929), where "dividends" paid on preferred stock issued to creditors to hold only until through dividends they had received a 100% bonus on a loan were held deductible interest. We have been referred to no case holding that the court could not look to "the actualities of the situation" in determining whether corporate distributions were in fact true dividends or interest on indebtedness. See Healy concurring in *Pacific Southwest R. Co.* v. *Commissioner*, 128 F. (2d) 815, 819 (C. C. A. 9th, 1942).

In *Commissioner* v. *H. P. Hood Sons, Inc.*, 141 F. (2d) 467 (C. C. A. 1st, 1944), this court sustained the Tax Court's determination that cumulative interest payments on 7% income debentures were deductible interest and said: "Al-

though the annual return on the instrument was payable 'only out of and to the extent of the net earnings' that pro-
[fol. 100] prietary feature is subordinate to the indebtedness feature calling for payment of all accumulated unpaid interest on the due date 'whether or not the available net earnings of the company are sufficient for such payments.' " In that case the debentures provided for a fixed rate of interest, the annual payment of which only was contingent upon the extent of the net earnings. There the taxpayer bound itself to pay on the maturity date "the face amount of the instrument together with 'all accumulated and/or accrued and unpaid interest' at the designated rate" of 7%. The taxpayer in the present case has not contracted to pay a fixed rate of interest regardless of whether or not its net earnings are sufficient. The payment of interest is deferable as in the *Hood* case, and in addition to that the rate itself is a variable rate ranging from 2% to 10% depending upon earnings, and it is determined at the end of the fiscal year. The rate is thus not fixed in advance, and until fixed it is contingent. "Stockholders have no absolute right to dividends until they are declared. A creditor has a right to his interest in any event." *Commissioner* v. *Meredian & Thirteen Realty Co., supra.* Here the determination of the rate of interest is geared to the making of profits by the taxpayer, and the note holder does not know in advance what the rate will be. It cannot be said of him therefore that he has a right to his interest "in any event" since he will not know until the end of the fiscal year what the rate will be, and the fixing of the rate is a condition precedent to the determination of the amount of interest due. In the light of all the facts in the case the provision that minimum and maximum rates have been set is not controlling. The notes authorize the directors to suspend the payment of interest when the needs of the business require such action. No provision is made for interest to be paid on such suspended payments, and they are subjected to the risks of the enterprise. These factors taken in con-
[fol. 101] junction with the provisions for subordination to the claim of creditors and the straight exchange feature of the transaction leaving the proportionate interests of the stockholders unaffected move us to conclude on the reasoning of the *Hood* case, *supra*, that the indebtedness feature is subordinate to the proprietary feature and to hold that

the "interest" on these notes is not "interest on indebtedness' deductible under § 23(b).

The question here presented turns on its special facts. We believe that the Tax Court was correct in holding that the payments made as "interest" were not deductible, and its decision must stand. *Dobson* v. *Commissioner*, 320 U. S. 489 (1944) rehearing denied 321 U. S. 231.

The decision of the Tax Court of the United States is affirmed.

MAGRUDER, J. (dissenting):

I do not regard as decisive the fact that the so-called "interest" to be paid on the "registered notes" is a variable rate contingent upon the amount of the corporation's net earnings. This feature, the government insists, is "the paramount proprietary characteristic" differentiating the equity interest of a shareholder from the debtor-creditor relationship. It has long been settled in the law of partnership that one may lend money to the proprietor of a business upon an agreement for the payment of interest not at a predetermined fixed rate but in a variable amount ascertained by reference to a percentage of the net profits, without thereby becoming a partner in the business and liable as a coproprietor for the business debts. See *Meehan* v. *Valentine*, 145 U. S. 611, 624 (1892). In the case of such a loan, the return paid to the lender under the agreement, though variable in amount from year to year, would surely [fol. 102] constitute "interest" within the meaning of § 23(b) of the Internal Revenue Code, since it would be the agreed "compensation for the use or forbearance of money." *Deputy* v. *du Pont*, 308 U. S. 488, 498 (1940).

Of course, the lending of money is not the only way an indebtedness may arise upon which interest is to be paid. Thus, upon the sale of goods, the buyer may agree to pay interest on the unpaid installments of the purchase price, and it may be provided that this interest shall be variable in amount contingent upon earnings. This would be deductible under § 23(b) quite as much as if the purchase money had been paid over to the seller and then lent back to the buyer.

And so, it is possible for a corporation to create an "indebtedness,' within the meaning of § 23(b), by an agreement under which the corporation redeems some of its stock

at par, and instead of paying cash therefor gives to the surrendering shareholders interest-bearing notes for the redemption price. The exchange of stock for notes would give rise to an "indebtedness," even though no new capital were thereby brought into the corporation.

The result would be no different if we assume that the main motive for the recapitalization was to achieve a tax advantage. *Commissioner* v. *H. P. Hood & Sons, Inc.*, 141 F. (2d) 467, 471 (C. C. A. 1, 1944). To test this, suppose that, at the organization of the corporation, the fifteen individuals who were to put up the money had considered the alternatives of having the corporation issue to them 5000 shares of stock at $100 a share, or 1000 shares of stock and ordinary interest-bearing notes in an amount of $400,000; and had decided on the latter course in order to give the corporation the advantage of the interest deduction under § 23(b). This advantage would have been achieved had they chosen the second alternative at the outset. Yet the [fol. 103] proportionate voting control of the original shareholders would have been the same either way, and their returns in the aggregate might have been the same either way—under the first alternative received solely as dividends, under the second partly in the form of dividends and partly as interest. If interest deductibility could be achieved by an original capitalization as above supposed, it could equally well be achieved by a subsequent recapitalization along the same lines.

Therefore I think we should lay aside as irrelevant two points stressed in the opinion of the Tax Court: (1) "The factor of tax avoidance loomed large in the minds of the parties by their own admission, and indeed appears to have been the only substantial purpose motivating the transaction"; and (2) "Each shareholder retained the precise voice in the management which he had prior to the transaction. He retained the same right to participate in the profits of the business; what he did not receive by way of interest he would take by way of dividends on his remaining stock."

Whether the registered notes are to be classified as evidences of indebtedness depends upon an analysis of their substantive provisions, not upon who holds them. It is not suggested that the notes are a sham, that is, that they do not embody the real understanding of the parties to the transaction. If the notes would have been evidences of in-

debtedness in the hands of outsiders, they are equally so in the hands of the group who also hold the outstanding stock. And if the notes would have been evidences of indebtedness had some of the original shareholders surrendered all their shares of stock in exchange for the notes, they cannot be anything different merely because each of the original shareholders surrendered four-fifths of his shares in exchange for a proportionate part of the notes, thereby leaving unaffected the relative voting control.

[fol. 104] From the foregoing I think it is clear that, had the notes in the present case been simple promissory notes in the conventional form, unencumbered by the special provisions which have been set forth in the opinion of the court, the amounts annually paid thereon would have been deductible as "interest * * * on indebtedness."

The special provisions in the notes do not require different conclusion. The provision for subordination is no novelty in debtor-creditor agreements. It happens to be the fact that, at the date of the hearing before the Tax Court, all the subordinations had been terminated by the payment of the obligations. In the event of bankruptcy, the holders of the notes would have provable claims *pari passu* with the other general creditors. As already indicated, the provision for a variable rate of interest, from a minimum of 2% to a maximum of 10%, depending on earnings, is wholly consistent with the existence of an indebtedness, and indeed provisions of that general type are not uncommon in debt-creating instruments. See *Meehan* v. *Valentine*, 145 U. S. 611 (1892); *Edwards* v. *Bay State Gas Co.*, 91 Fed. 946 (C. C. D. Del., 1898). The minimum of 2% is not contingent upon earnings, and payment of this 2% by the corporation would certainly not be in violation of provisions in the various corporation laws against payment of dividends out of anything but earnings or surplus. True, the corporation under certain conditions may defer the payment of the stipulated interest, not, however, beyond the maturity date of the principal. This, again, is a proper matter of agreement between debtor and creditor.

In other words, the notes are characteristic evidences of indebtedness, in that (1) they contain an unqualified obligation to make a fixed principal payment on a day certain (which may be accelerated under certain conditions, but

[fol. 105] not postponed);[1] (2) they carry no voting power or voice in management of the obligor's business;[2] and (3), at least outside the field of taxation, the notes would be given effect according to their terms, and the holders of the notes would have the recognized status of creditors.

Of course, Congress might restrict the deduction for interest to cases where interest is payable at a fixed rate irrespective of earnings. This is exclusively a matter of legislative policy. So far, no such restriction has been put into the Act. The courts are bound by the unqualified statutory command in § 23(b) that deduction shall be allowed for "*all interest* paid or accrued within the taxable year on indebtedness" [italics added]—with one exception not now relevant.

In the case at bar, there is no disputed question of fact relevant to the issue to be decided. The terms of the notes speak for themselves, and their legal effect, that is, whether they constitute evidences of "indebtedness" within the meaning of § 23(b), is a question of law. This is not even the kind of legal question with which the Tax Court may be assumed to have specialized familiarity, for the legal effect of the instruments as constituting an indebtedness may arise in many ways outside the tax field, and there is no indication that Congress meant the word "indebtedness" to have any peculiar meaning in § 23(b). Congress has given the circuit courts of appeals authority to modify or reverse decisions of the Tax Court if "not in accordance with law" (44 Stat. 110). The reports of the Senate and [fol. 106] House committees state pretty clearly what Congress meant by that; one of the "questions of law" which the reports say courts may consider on review is "the proper interpretation and application of the statute or any regulation having the force of law." H. R. Rep. No. 1, 69th Cong., 1st Sess. (1925), p. 19; Sen. Rep. No. 52, 69th Cong.,

[1] To further assure the fulfillment of this obligation, the notes provide that no corporate mortgage shall be made to secure an obligation maturing later than the due date of the notes, and that no subordination agreement shall extend beyond such due date.

[2] If the original shareholders should transfer their remaining shares of stock, they would cease to have any voting power in the corporation, though they still held on to the notes.

1st Sess. (1926), pp. 36-37. Prior to *Dobson* v. *Commissioner*, 320 U. S. 489 (1943), the circuit courts of appeals would certainly have been considered free to make an independent review of issues such as that in the present case. *Helvering* v. *American Dental Co.*, 318 U. S. 322 (1943); *Powers* v. *Commissioner*, 312 U. S. 259 (1941). I think the reviewing courts should continue to assume that this is so, until the Supreme Court explicitly tells us otherwise. The *Dobson* opinion, to my reading, contains no such explicit direction. *Cf. Security Flour Mills Co.* v. *Commissioner*, 321 U. S. 281 (1944); *Norton* v. *Warner Co.*, 321 U. S. 565, 569 (1944).

Such being my view, with all deference I dissent from the opinion and judgment of the court.

On the same date, to wit, December 22, 1944, the following Final Decree was entered:

FINAL DECREE—December 22, 1944

This cause came on to be heard November 8, 1944, upon the record on petition for review of a decision of The Tax Court of the United States, and was argued by counsel.

Upon consideration whereof, It is now, to wit, December 22, 1944, here ordered, adjudged and decreed as follows: The decision of the Tax Court of the United States is affirmed.

By the Court,

(S.) Arthur I. Charron, Clerk.

[fol. 107] Thereafter, to wit, on January 8, 1945, mandate issued.

Clerk's Certificate to foregoing transcript omitted in printing.

[fol. 108] SUPREME COURT OF THE UNITED STATES

ORDER ALLOWING CERTIORARI—Filed April 30, 1945

The petition herein for a writ of certiorari to the United States Circuit Court of Appeals for the First Circuit is granted, and the case is transferred to the summary docket and assigned for argument immediately following No. 948, The John Kelley Co. v. Commissioner of Internal Revenue.

And it is further ordered that the duly certified copy of the transcript of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ.

FILE COPY

Office - Supreme Court, U. S.
FILED
MAR 23 1945
CHARLES ELMORE CROPLEY
CLERK

In the Supreme Court of the United States

OCTOBER TERM 1944

No. 1070 47

TALBOT MILLS,

Petitioner

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIRST CIRCUIT

BRIEF IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI

MELVILLE F. WESTON,
Counsel for Petitioner.
TALBOT MILLS.

POWERS & HALL
Of Counsel.

In the Supreme Court of the United States

OCTOBER TERM 1944

No.

TALBOT MILLS,

Petitioner

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIRST CIRCUIT

TO THE HONORABLE THE JUDGES OF THE SUPREME COURT OF THE UNITED STATES:

Talbot Mills, a Massachusetts corporation, prays that a writ of certiorari issue to review the decision of the Circuit Court of Appeals for the First Circuit, entered in the above case on December 22, 1944, affirming a decision of the Tax Court of the United States entered February 12, 1944.

STATEMENT OF THE MATTER INVOLVED

The Respondent determined a deficiency in Petitioner's Income and Excess Profits Tax liability for the Petitioner's taxable (fiscal) year ended September 30, 1940 (R. 57–59). Petitioner applied to the Tax Court of the United States for a redetermination of the deficiency (R. 3–6). The Tax Court sustained the Respondent's determination of a deficiency

(R. 73–81, 85). Petitioner duly sought review by the United States Circuit Court of Appeals for the First Circuit (R. 86–7). The Circuit Court of Appeals, one judge dissenting, affirmed the decision of the Tax Court (R. 93–106).

The deficiency was based upon the disallowance by the Respondent of $40,000 which the Petitioner had deducted as interest upon its return (R. 59, 73, 93–94). This was interest on the Petitioner's issue of registered notes, outstanding in the aggregate face value of $400,000 (R. 74, 95). A specimen of these notes appears in the record (R. 19–25). It was stipulated that the item of $40,000 was properly accrued for and on account of the taxable year in question (R. 14–15). The issue was whether such item, so accrued, constituted interest deductible within the meaning of Section 23 (b) of the Internal Revenue Code (R. 59, 3–6, 14–15, 73, 78, 97).

The central and dominant feature of Petitioner's notes was an unqualified promise to pay to each payee a fixed sum of dollars at a definite maturity, slightly over twenty-five (25) years after the date of issue (R. 19, 74, 95). The Petitioner further promised to pay to each payee, as interest upon such fixed amount of principal, not less than 2 per cent (2%) nor more than ten per cent, (10%) in each year, within which range the actual rate in each year was to be determined by a formula having reference to the Petitioner's earnings for such year (R. 20, 75, 95). Interest for the year ended September 30, 1940, was determined at the rate of 10 per cent. in accordance with these provisions (R. 48, 78, 96–97) being the $40,000 the deduction whereof is in question (R. 78, 93).

Nowhere in the Commissioner's pleadings or in the findings of the Tax Court or in the opinion of the Circuit Court of Appeals can be found any suggestion that the promises embodied in the Petitioner's notes were not genuine, made in good faith, and intended to be performed in accordance with their terms. There was no suggestion that the notes were a "sham," or that they did not embody the real understanding of the parties to the transaction.[1]

[1] See specifically the dissenting opinion (R. 103)

Nevertheless, the Tax Court held that the notes did not create any "proper indebtedness," that they "were more in the nature of a capital investment than a loan to the corporation," and that the payments made as interest were not deductible under Section 23 (b) of the Internal Revenue Code (R. 81).

The Tax Court based its conclusion upon the circumstances: (a) that the notes bore a "variable rate of interest computed with reference to profits" (R. 79); (b) that they were "issued in exchange for stock of the issuing corporation" (R. 79, 80); (c) that the notes provided under certain circumstances that "the payment of interest might be deferred" (R. 79); and (d) that the "factor of tax avoidance" was a "substantial purpose motivating the transaction" (R. 80). It asserted that the "cumulation of these various restrictive features . . . tends to cast doubt on the real nature of the instant transaction" (R. 80); that therefore the intent of the parties must be sought, with evidence *aliunde* the contract admissible (R. 80); and that "what the parties really intended to create was a security retaining the profit-sharing advantage of stock, leaving intact their voice in the management,[2] but extending a tax advantage to the corporation not possible in stock" (R. 80–81).

The Circuit Court of Appeals based its decision upon the circumstances that the notes were issued in exchange for stock (R. 98, 101); that the rate of interest was variable (R. 99–100); that the notes were capable of being subordinated to the claims of other creditors (R. 101); that the payment of interest could be deferred (R. 100); and that Petitioner had tax avoidance as a motive in the issuance of notes in exchange for stock (R. 98–99). It also held that the meaning of the notes was governed by extrinsic evidence (R. 98, 99). In addition, the Court relied upon *Dobson* v. *Commissioner*, 320 U. S. 489 (1943) as requiring that the Tax Court be upheld.

---

[2] Ignoring the obvious fact that this right was attached only to the stock, not to the notes.

Both the Tax Court and the Circuit Court of Appeals also apparently regarded as material the facts that the Petitioner had but few stockholders, who were related by blood or marriage; that the noteholders also continued to hold stock; and that but few of the notes had been transferred to date (R. 74, 76, 80, 94, 98, 99).

The Tax Court and the Circuit Court of Appeals both ignored the strong categorical language of I.R.C. Section 23 (b) providing that deduction shall be allowed for *"all interest* paid or accrued within the taxable year on indebtedness" (italics added). Both paid as little regard as possible to the fundamental fact that the notes embodied a firm promise to pay a fixed sum of money at a fixed maturity, which, at least for every purpose other than taxation, would unquestionably constitute an indebtedness. Both concerned themselves with "tax motives." The tenor of both decisions is made sharply clear by the contrast presented by the dissenting opinion of Judge Magruder (R. 101).

The Petitioner submits that the decision of the Circuit Court should be reviewed by this Court upon certiorari, for the reasons stated below, in support whereof a brief is filed herewith.

REASONS RELIED ON FOR THE ALLOWANCE OF THE WRIT

Under the principles enunciated in Section 5 (b) of Rule 38 of this Court, the Petitioner submits that the writ should be granted for the following reasons:

1. The decision is in substance in conflict with the decision of the Circuit Court of Appeals for the Second Circuit in *Commissioner* v. *O.P.P. Holding Corporation,* 76 F. 2d 11 (C.C.A. 2nd, 1935).

2. The Circuit Court of Appeals has decided federal questions in a way probably in conflict with applicable decisions of this Court in at least the following respects:

(a) With respect to the meaning of "interest" as used

in the tax statutes—*Deputy* v. *Dupont*, 308 U. S. 488, 84 L. Ed. 416 (1940).

(b) With respect to the propriety of stipulating for a variable rate of interest computed with reference to profits—*Meehan* v. *Valentine*, 145 U. S. 611, 36 L. Ed. 835 (1892).

(c) With respect to proper principles of construction, giving to words in the tax statutes their plain and natural meaning—*Deputy* v. *Dupont*, *Supra*.

(d) With respect to the construction of tax statutes in favor of taxpayers in proper cases—*Gould* v. *Gould*, 245 U. S. 151, 62 L. Ed. 211 (1917).

(e) With respect to when "evidence *aliunde* the contract" may be used to control the meaning of a written instrument—*Hamilton* v. *Liverpool, etc. Ins. Co.* 136 U. S. 232, 34 L. Ed. 419 (1890).

(f) With respect to the right of taxpayers to arrange their affairs with an eye to tax consequences—*Bullen* v. *Wisconsin*, 240 U. S. 625, 60 L. Ed. 830 (1916).

(g) With respect to a proper regard to the actual language used by Congress and to refraining from judicial legislation—*Crooks* v. *Harrelson*, 282 U. S. 55, 75 L. Ed. 156 (1930); *Iselin* v. *United States*, 270 U. S. 245, 70 L. Ed. 566 (1926).

(h) With respect to the application of the rule making decisions of the Tax Court final in respect of matters of fact but not in respect of matters of law—*Dobson* v. *Commissioner*, 320 U. S. 489; 88 L. Ed. 179 (1943).

3. The Circuit Court of Appeals has decided important questions of federal law which have not been, but should be, settled by this Court because of,

(a) Their importance in the administration of the tax laws;

(b) Their importance to citizens of the Country about their commercial affairs;

(c) Their importance with respect to permissible judicial methods.

Each of the grounds mentioned above will be expanded and supported in the Petitioner's brief.

Wherefore, your Petitioner respectfully prays that a writ of certiorari be issued to the United States Circuit Court of Appeals for the First Circuit for a review of the decision of the Circuit Court of Appeals and that the judgment of the Circuit Court of Appeals be reversed and that the Petitioner be granted such other and further relief as may be proper.

MELVILLE F. WESTON,
Counsel for Petitioner.
TALBOT MILLS.

POWERS & HALL
Of Counsel.

INDEX TO BRIEF

(And to Petition)

PETITION

	PAGE
Statement of the Matter Involved	1
Reasons relied on for the Allowance of the Writ	4

BRIEF

Opinions Below	7
Jurisdiction	7
Statement of the Case	8
Characteristics of Petitioner's Notes	8
Specification of Errors	9
Summary of Argument	11
Argument	12–27
I. The decision of the Circuit Court of Appeals for the First Circuit is in conflict with *Commissioner* v. *O.P.P. Holding Corporation*, 76 F. 2d 11, Decided in 1935 by the Circuit Court of Appeals for the Second Circuit	12–13
II. The decision of the Circuit Court of Appeals for the First Circuit is in probable conflict with numerous decisions of this Court	13–23
A. The meaning of "interest on indebtedness." Herein of the variable rate of interest	13–15
B. Rules for the construction of statutes —Ordinary meaning of terms— Construction in taxpayer's favor	15–17
C. The use of "evidence *aliunde* the contract"	17–19

D. As to the right of the Petitioner to rearrange its affairs with frank regard to minimizing the incidence of taxation 19–20

E. The inapplicability of *Dobson* v. *Commissioner* 20–23

III. The questions of law presented are of importance and should be decided by this Court 23–27

A. The issues are important in the administration of the revenue laws 23–24

B. The issues are important to the security of commercial transactions 24–25

C. The issues presented are of importance with respect to the judicial process itself 25–27

TABLE OF CASES CITED

(Including Citations in Petition)

	PAGE
Arthur R. Jones Syndicate v. *Commissioner*, 23 F. 2d 8[illegible] (C.C.A. 7th, 1927)	11, 18
Brown v. *J. C. Shaffer Grain Co.*, 15 F. 2d 514 (C.C.A. 1st, 1926)	17
Bullen v. *Wisconsin*, 240 U. S. 625, 60 L. Ed. 830 (1916)	5, 19, 20
Commissioner v. *Coastwise Transportation Corp.*, 71, F. 2d 104, 105, (C.C.A. 1st, 1934)	17
Commissioner v. *John Kelley Co.*, 146 F. 2d 466, 468, (C.C.A. 7th, 1944)	24, 26
Commissioner v. *O.P.P. Holding Corporation*, 76, F. 2d 11, (C.C.A. 2nd, 1935)	4, 12, 13, 25
Commissioner v. *Proctor Shop Inc.* 82 F. 2d 792, 794 (C.C.A. 9th, 1936)	18, 23
Commissioner v. *Raphael*, 133 F. 2d 442, 445 (C.C.A. 9th, 1943)	21
Crooks v. *Harrelson*, 282 U. S. 55, 75 L. Ed. 156, 175 (1930)	5, 20
H. R. Demitt Co., 7 BTA 7	24
Deputy v. *Dupont*, 308 U. S. 488, 84 L. Ed. 416 (1940)	5, 14, 15, 16
Diamond Calk Horse Shoe Co. v. *United States*, D.C.D. Minn. 7/20/40, CCH Par. 9641; Appeal Dismissed on Stipulation 116 F. 2d 284	24
Dobson v. *Commissioner*, 320 U. S. 489, 88 L. Ed. 179 (1943)	3, 5, 11, 20, 21, 24

Equitable Life Assurance Society v. *Commissioner*, U. S. , 88 L. Ed. 603 (1944) 16

Forstman v. *Rogers*, 128 F. 2d 126, 129 (C.C.A. 3d, 1942) 20

Gregory v. *Helvering*, 293 U. S. 465 ..... 11, 19

Gould v. *Gould*, 245 U. S. 151, 62 L. Ed. 211 (1917) . 5, 16, 17

Guaranty Savings & Loan Co., 14 BTA 72 24

Hamilton v. *Liverpool, etc. Ins. Co.*, 136 U. S. 242, 34 L. Ed. 419 (1890) 5, 17

Helvering v. *Northwest Steel Rolling Mills*, 311 U. S. 45, 85 L. Ed. 29 (1940) 16

Helvering v. *Ohio Leather Co.*, 317 U. S. 102, 87 L. Ed. 113 (1942) 16

Helvering v. *Richmond F. & P. R. Co.*, 90 F. 2d 971, (C.C.A. 4th, 1937) 23

Iselin v. *United States*, 270 U. S. 245, 251; 70 L. Ed. 566, 69-70 (1926) 5, 20

John Kelley Co., 1 T.C. 457 24

Kena, Inc., 44 B.T.A. 217 15

S. S. Kresge Co. v. *Sears*, 87 F. 2d 135, 138, 140 (C.C.A. 1st, 1936) 17

S. H. Kress Co. v. *Fisher*, 65 F. 2d 682, 683 (C.C.A. 4th, 1933) 18

Mead Corporation v. *Commissioner*, 116 F. 2d 187, 191 (C.C.A. 3d, 1940) 20

Meehan v. *Valentine*, 145 U. S. 611; 36 L. Ed. 835 (1892) 5, 14

Meridian and Thirteenth Realty Co., 44 BTA 865 24

Merinos Viesca Y Compania v. *Pan American P & T Co.*, 83 F. 2d, 240, 242 (C.C.A. 2d 1936) 18

National Surety Corp. v. *Ellison*, 88 F. 2d 399, 403 (C.C.A. 8th, 1937) 18

New Colonial Ice Co. v. *Helvering*, 292 U. S. 435, 78 L. Ed. 1348 (1934) 16

Noteman v. *Welch*, 108 F. 2d 206, 208, 215 (C.C.A. 1st, 1939) 20

Old Colony Railroad Co. v. *Commissioner*, 284 U. S. 552, 560, 76 L. Ed. 484, 489 (1932) 15

Palmer, Stacy-Merrill, Inc. 39 BTA 636, Affmd. 111 F. 2d 809 24

Union State Bank & Tr. Co. v. *Northwestern Life Ins. Co.* 55 F. 2d 1070, 1072 (C.C.A. 5th, 1932) .. 17

Western & Southern Life Ins. Co. v. *Huwe*, 116 F. 2d 1008, 1010, (C.C.A. 6th, 1941) 20

White v. *United States*, 305 U. S. 281, 82 L. Ed. 172 (1938) 16

Wiggin Terminals v. *United States*, 36 F. 2d 893 11

Woolford Realty Co. v. *Rose*, 286 U. S. 319, 76 L. Ed. 1128 (1932) 16

Internal Revenue Code, Section 23 (b) .. 2, 4, 7, 9, 15, 20

Judicial Code, Section 240 (a) (U. S. Code, Title 28, Section 347 (a)) 7

Act of February 13, 1925 (U. S. Code, Title 28, Section 350) 8

In the Supreme Court of the United States

OCTOBER TERM 1944

No.

TALBOT MILLS,

Petitioner

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent

BRIEF IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI

Talbot Mills, a Massachusetts corporation, respectfully submits this brief in support of its petition for a writ of certiorari, printed and filed herewith.

OPINIONS BELOW

The opinion of the Circuit Court of Appeals (R. 93) is reported in F. 2d . The opinion of the Tax Court (R. 73-81) does not appear yet to be officia ly reported, the presently available reference being 3 T.C. , No. 11. An unofficial report may be found in the CCH Tax Court Service, Volume 2, Dec. 13,691.

JURISDICTION

A. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code as amended by the Act of February 13, 1925 (U. S. Code, Title 28, Section 347 (a)).

B. The case involves the construction and application of Internal Revenue Code, Section 23 (b), providing that in computing net income there shall be allowed as a deduction all interest paid or accrued within the taxable year on indebt-

edness (with an exception not material). This deduction has been denied to the Petitioner in violation of applicable principles of law, as hereinafter set forth. That the issues are substantial appears well confirmed by the dissenting opinion in the Circuit Court of Appeals and by the matters presented hereinafter in this brief.

C. The decision of the Circuit Court of Appeals was entered December 22, 1944. This petition, in accordance with the requirements of the Act of February 13, 1925 (U. S. Code, Title 28, Section 350) will be filed within three months after the above-mentioned date.

STATEMENT OF THE CASE

The "Statement of the Matter Involved," found at pages 1-4 of the Petition, *supra,* contains in summary form the facts material to the consideration of the questions presented, with references to the pages of the record. For the sake of brevity, we do not repeat this material here but respectfully incorporate it by reference.

The pertinent provisions of the petitioner's notes, with references to the full text as it appears at pages 19-23 of the printed record, are as follows:

(a) The unqualified promise to pay a fixed sum in dollars at maturity on December 1, 1964 (R. 19).

(b) The agreement to pay interest at not less than 2% and not more than 10%, and, within that range at the rate (to the nearest ¼%) which a sum equal to two-thirds (⅔) of the Petitioner's net earnings for the fiscal year would represent upon an assumed principal of $400,000 (R. 20).

(c) The agreement to pay interest under certain circumstances at the flat rate of 6% (R. 20, 21, 22).

(d) The power of the Petitioner to defer payment of interest, only as the Directors in good faith determine to be necessary, and in no event beyond December 1, 1964 (R. 20).

(e) Acceleration of maturity in event of bankruptcy and the like (R. 21).

(f) The power of the Petitioner to effect subordinations to other obligations maturing not later than December 1, 1964. Note that there was no general subordination, only a power to make (and, under proper conditions, terminate) subordinations (R. 21-22).

(g) The power to call and retire the notes (R. 22-23).

(h) The power of three-fifths (3/5) of the noteholders to consent to changes, not affecting the fundamental obligations (R. 23-24).

(i) Provisions affecting transferability (R. 24).

The recapitalization, in the course of which the notes were issued, is set out in the record (R. 10-13; 18-19; 26-28; 36-39; 41-45).

Certain specific subordinations, since terminated, are set out in the record (R. 14; 29-35; 44-45; 46-47;).

The statute under which the deduction is claimed is as follows:

INTERNAL REVENUE CODE

Sec. 23. DEDUCTIONS FROM GROSS INCOME

In computing net income there shall be allowed as deductions:

(b) *Interest.*—All interest paid or accrued within the taxable year on indebtedness, except . . ." (Exception not material)

SPECIFICATION OF ERRORS

The Petitioner specifies, and will urge upon the granting of the writ, the following errors committed by the Circuit Court of Appeals.

1. The Court erred in holding that the sums accrued as interest upon the Petitioner's outstanding registered notes were not deductible as interest under Internal Revenue Code, Section 23 (b).

2. The Court erred in applying a rule which makes only some interest upon some indebtedness deductible, whereas the statute grants a deduction to *all* interest upon indebtedness.

3. The Court erred in failing to construe the term "interest" in said statute as including the amounts accrued upon the Petitioner's registered notes.

4. The Court erred in failing to attribute to the terms "interest" and "indebtedness" in said statute their plain and natural meaning as reflected in common usage and general law.

5. The Court erred in failing to construe the term "indebtedness" in the statute as including the principal obligation created by the Petitioner's registered notes.

6. The Court erred in construing the statute by the application of an untenable distinction between "loans" and "capital investments."

7. The Court erred in using extrinsic evidence to control the meaning of Petitioner's notes.

8. The Court erred in applying criteria, applicable only in cases of alleged sham and the like, to a case in which there was in fact no question and no issue but that the Petitioner's notes were genuine and intended to be enforced according to their terms.

9. The Court erred in holding in effect that interest, to be deductible under the statute, must not be at a rate measured with reference to profits.

10. The Court erred in regarding and making the basis of its decision such factors as:

(a) That the Petitioner's notes were issued in exchange for stock;

(b) That the Petitioner's notes provided for a variable rate of interest;

(c) That the Petitioner's notes brought no new capital into the corporation;

(d) That the Petitioner's notes were capable of being subordinated to claims of other creditors;

(e) That under the provisions of Petitioner's notes payments of interest might be deferred;

(f) That Petitioner's notes were held by persons who were also stockholders;

(g) That the holders of Petitioner's notes were related by blood or marriage.

11. The Court erred in regarding and making the basis of its decision, the circumstance that a tax advantage was a principal purpose of the recapitalization in which Petitioner's notes were issued.

12. The Court erred in treating the indebtedness actually created by the Petitioner's notes as if it were "form" instead of "substance" in a case in which there was neither evidence nor suggestion of sham or unreality, or of a temporary expedient (Cf. *Gregory* v. *Helvering*, 293 U. S. 465), or of a transaction for security only or to achieve some other unrelated end (Cf. *Wiggin Terminals* v. *United States*, 36 F. 2d 893; *Arthur R. Jones Syndicate* v. *Commissioner*, 23 F. 2d 833).

13. The Court erred in failing to apply the rule of construing tax statutes in favor of the taxpayer, in a case where the application of such rule merely required giving to the language of the statute its plain, straightforward meaning.

14. The Court erred in applying the rule of *Dobson* v. *Commissioner*, 320 U. S. 489, in a case in which the fundamental issues involved were issues of law and not of fact.

SUMMARY OF ARGUMENT

It is respectfully submitted that this Court should consent to review this case because of its importance in the administration of the revenue laws, its importance with respect to past, present and future dealings of business organizations throughout the Country with respect to their financial arrangements, and finally its importance with respect to the judicial process itself.

The decision of the Circuit Court of Appeals for the First Circuit is in essence incompatible with the leading case upon a like subject matter in the Second Circuit.

In reaching its decision, the Circuit Court of Appeals of necessity violates clear principles set out in the decisions of this Court with respect to the construction and interpretation of statutes; the meanings of the terms "interest" and "indebtedness"; the duty of courts not to vary the clear meaning of a genuine unambiguous written instrument by recourse to so-called "evidence *aliunde* the contract"; the right of citizens to arrange their affairs with a view to the minimum incidence of taxation; the duty of the courts to refrain from "judicial legislation"; and the reviewability of decisions of the Tax Court upon issues of law.

The Petitioner protests against a judicial technique which, with the almost palpable objective of defeating the Petitioner's purpose to minimize the incidence of taxation, disregards the express language of the statute, treats a genuine business arrangement as if it were a sham although no issue of sham exists, disregards applicable rules for the construction of statutes, in effect asserts the existence of a common law of taxation with a right to control and alter the statutes enacted by Congress, discriminates against the Petitioner because it is owned by a few people instead of by many, and in general deprives it and all others similarly situated of their clear rights under the law. That the Petitioner is aggrieved, may by itself be no basis for the issuance of the writ. But the interests imparied by the establishment of any grossly erroneous judicial technique are the interests of the whole people.

ARGUMENT

I. THE DECISION OF THE CIRCUIT COURT OF APPEALS FOR THE FIRST CIRCUIT IS IN CONFLICT WITH *Commissioner* v. *O.P.P. Holding Corporation*, 76 F. 2d 11, DECIDED IN 1935 BY THE CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT.

In the case mentioned above, the debenture bonds in question obligated the corporation to pay fixed sums of money at a definite maturity date. The interest thereon was held to be deductible in spite of the facts that (a) two-thirds of the outstanding bonds might extend the maturity date for all;

(b) the bonds were subordinated to the claims of general creditors; and (c) the Company might at its option suspend or defer the payment of interest provided it was not relieved of "the obligation to pay the same at some future time." It was held that the interest upon these bonds was deductible and the emphasis of the Court was correctly placed, at p. 12, upon the central fact that the creditor was entitled to be paid eventually from the debtor's property, regardless of whether there should be a surplus.

In the present case, the Tax Court and the Circuit Court of Appeals have ignored this central feature, which is the dominant characteristic of an indebtedness, and have placed their emphasis upon subordinate features, every one of which is a proper incident of an indebtedness and, based upon these subordinate features, have arrived at the conclusion that there was no "proper" indebtedness.

Distinctions drawn between the two cases, merely because exactly the same set of subordinate features was not present in both cases,[1] cannot properly account for the difference in the results. Further, any attempt to rest the distinction solely upon the fact that the present Petitioner's notes contained a variable rate of interest would be unsound under decisions of this Court (see pp. 14-15, *infra*).

II. THE DECISION OF THE CIRCUIT COURT OF APPEALS FOR THE FIRST CIRCUIT IS IN PROBABLE CONFLICT WITH NUMEROUS DECISIONS OF THIS COURT.

A. *The meaning of "interest on indebtedness"—Herein of the variable rate of interest.*

[1] For example the *O.P.P. Holding Company* case did not contain the element of a variable rate of interest or the element of notes having been issued in exchange for stock. On the other hand, the Talbot Mills notes did not authorize two-thirds of the bonds to extend the maturity date and did not provide an absolute subordination to the claims of other creditors but only an authority to vote and terminate specific subordinations.

In *Deputy* v. *Dupont*, 308 U. S. 488, 84 L. Ed. 416 (1940), this Court said:

> "In the business world, 'interest on indebtedness' means compensation for the use or forbearance of money. In absence of clear evidence to the contrary, we assume that Congress has used these words in that sense. In sum, we cannot sacrifice the 'plain, obvious and rational meaning' of the statute even for 'the exigency of a hard case.'" 308 U. S. p. 498; 84 L. Ed. p. 424.

The carefully selected words "compensation for the use or forbearance of money" definitely exclude from consideration the question whether the debt was incurred as the purchase price of the debtor's own stock. Obviously there is "forbearance of money" so long as the creditor, voluntarily or in accordance with his written contract, forbears to receive from the debtor the sum owned. And a sum may become owing for any valuable consideration. Manifestly the surrender of the Petitioner's stock in the present case was such a valuable consideration.[2]

In *Meehan* v. *Valentine*, 145 U. S. 611, 36 L. Ed. 835, this Court said, as follows:

> "In whatever form the rule is expressed, it is universally held that an agent or servant, whose compensation is measured by certain proportion of the profits of the partnership business, is not thereby made a partner, in any sense. So an agreement that the lessor of a hotel shall receive a certain portion of the profits thereof by way of rent does not make him a partner with the lessee. . . . And it is now equally well settled that the receiving of part of the profits of a commercial partnership, in lieu of or in addition to interest, by way of compensation for a loan of money, has of itself no greater effect." 145 U. S. p. 624; 36 L. Ed. p. 841.

It seems perfectly clear that it is a legitimate, and may be a wise, arrangement for a creditor to make with a debtor that the rate of pay which he is to receive for his forbearance of

[2] See dissenting opinion of Magruder, J. (R. 102).

money be related to the success of the debtor during the term of forbearance. And if such an arrangement with a partnership, which is not a separate legal entity, does not make the creditor a partner, *a fortiori* such an arrangement with a corporation, which is a legal entity, can hardly of its own force render the creditor a stockholder.[3] Even the Tax Court itself has held that interest may properly be measured in relationship to the debtor's earnings. See *Kena, Inc.*, 44 B.T.A. 217.

It follows that it was not proper for the Court below to rest its decision upon the feature of the variable rate of interest. Nor would it be according due regard to the decisions of this Court to say that this feature, in combination with other features, every one of which are common permissible arrangements in connection with an indebtedness, turns a creditor into a stockholder when each feature by itself has no lawful tendency to do so.

B. *Rules for the construction of statutes—Ordinary meaning of terms—Construction in taxpayer's favor.*

In *Deputy* v. *Du Pont, supra,* this Court said,[4]

> "And when it comes to construction of the statutory provision under which the deduction is sought, the general rule that 'popular or received import of words furnishes the general rule for the interpretation of public laws,' . . . is applicable." 308 U. S. p. 493; 84 L. Ed. p. 421.

Thereupon, as an illustration of this principle, the Court offered the definition of interest quoted above (see p. 14, *Supra*).

Internal Revenue Code, Section 23 (b), in the strongest possible terms, grants a deduction for "all interest . . . on indebtedness." One may well ask how Congress could have made the language stronger—unless, indeed, it is to be held the duty of the legislative, when trying to attain inclusive-

[3] See dissenting opinion of Magruder, J. (R. 101–2, 104).

[4] Accord, *Old Colony Railroad Co.* v. *Commissioner,* 284 U. S. 552, 560, 76 L. Ed. 484, 489 (1932).

ness, to clutter up the statutes with such expressions as "of all kinds, manners and descriptions whatsoever."

It is so obvious as to need no argument, and indeed to be almost incapable of argument, that in common parlance as well as general law the Petitioner's notes, with their central unqualified obligation to pay a fixed sum at a fixed maturity, were the written evidences of an indebtedness. And, if they were, it necessarily follows that the amount paid to service the debt was interest, however fragile, qualified or complicated the interest terms might be. Interest is no necessary feature of an indebtedness. There are debts which do not bear interest. And, if that is so, then, given a debt, it follows that any not unlawful stipulation with respect to the compensation to be paid for forbearance of the debt is interest. It is impossible to arrive at the result reached by the Tax Court and the Circuit Court of Appeals without coming in conflict with *Deputy* v. *Dupont, supra.*

In *Gould* v. *Gould,* 245 U. S. 151, 62 L. Ed. 211 (1917), this Court said,

> "In case of doubt," tax statutes "are construed most strongly against the government, and in favor of the citizen." 245 U. S. p. 153; 62 L. Ed. p. 213.

This rule is thoroughly capable of being reconciled with the rule of "strict construction" of exemptions, credits, deductions and the like, found in such cases as *Woolford Realty Co.* v. *Rose,* 286 U. S. 319, 76 L. Ed. 1128 (1932).

Careful examination of cases of the latter sort [5] will show

---

[5] *New Colonial Ice Co.* v. *Helvering,* 292 U. S. 435, 78 L. Ed. 1348 (1934)
White v. *United States,* 305 U. S. 281, 83 L. Ed. 172 (1938)
Deputy v. *DuPont,* 308 U. S. 488, 84 L. Ed. 416 (1940)
Helvering v. *Northwest Steel Rolling Mills,* 311 U. S. 45, 85 L. Ed. 29 (1940)
Helvering v. *Ohio Leather Co.,* 317 U. S. 102, 87 L. Ed. 113 (1942)
Equitable Life Assurance Society v. *Commissioner,* U. S. , 88 L. Ed. 603 (1944)

that they have never expressly overruled the decisions for construction in the taxpayer's favor, that they have never used the "strict construction" rule to deprive a taxpayer of the benefit of plain, fair, ordinary meaning of a provision establishing a deduction, and that the rule of strict construction has only been used to deny claims for the extension or expansion, by implication, of deduction sections, or to refute arguments which would have precluded the Court from exercising its proper judicial function in the resolving of genuine questions of construction.

It takes little more than lip service to the principle enunciated in *Gould* v. *Gould* to reach the conclusion in the present case that a statute providing for the deduction of *all* interest on indebtedness may not by judicial construction be cut down into a deduction of some types of interest on some indebtedness. Unless and until the principle of *Gould* v. *Gould* is expressly overruled by this Court, the decision below stands in inescapable conflict with it.

C. The use of "evidence aliunde the contract."

In *Hamilton* v. *Liverpool, etc. Ins. Co.*, 136 U. S. 242, 34 L. Ed. 419 (1890), this Court said that construction of the correspondence in writing between the parties presented a pure question of law to be decided by the Court.[6] In the present case, there is a complete and integrated document

---

[6] The general proposition here adduced may be viewed as an important question of general law and not merely as involving a federal question by reason of being raised in this case in conjunction with the application of a federal statute.—See in further support of the principle,

Commissioner v. *Coastwise Transportation Corp.*, 71 F. 2d 104, 105, (C.C.A. 1st, 1934)

Brown v. *J. C. Shaffer Grain Co.*, 15 F. 2d 514 (C.C.A. 1st, 1926)

S. S. Kresge Co. v. *Sears*, 87 F. 2d 135, 138, 140 (C.C.A. 1st, 1936)

Union State Bank & Tr. Co. v. *Northwestern Life Ins. Co.*, 55 F. 2d 1070, 1072 (C.C.A. 5th, 1932)

of the sort with respect to which loose ends are never intentionally left and which, by virtue of intended transferability, is the least subject to be controlled by extrinsic evidence.

The Court below, in the course of reaching a particular tax result, has talked about "consideration of the relevant facts," about looking to "actualities of the situation," about looking to see whether interest may be regarded as the "further distribution of profits" and about "exalting form above substance." We freely concede that if there had been precipitated an issue with respect to whether the notes were not genuine but a sham (or any other like issue involving the unreality of appearances),[7] all such language might have been relevant, but we also submit that upon this record there is neither any evidence upon which such an issue could have been based nor any indication of the purpose of the government to raise such an issue.[8]

It was therefore completely erroneous for the Tax Court and the Circuit Court of Appeals to hold themselves entitled to consider such facts as that the Petitioner was owned by a few stockholders (R. 74, 80, 94, 98), or that the stockholders were relatives (R. 74, 80, 94, 98), or that the noteholders acquired their notes through giving up

---

S. H. Kress Co. v. *Fisher*, 65 F. 2d 682, 683 (C.C.A. 4th, 1933)

Merinos Viesca Y Compania v. *Pan American P & T Co.*, 55 F. 2d 1070, 1072 (C.C.A. 5th, 1932)

National Surety Corp v. *Ellison*, 88 F. 2d 399, 403 (C.C.A. 8th, 1937)

[7] An example of such a case is *Arthur R. Jones Syndicate* v. *Commissioner*, 23 F. 2d 833 (C.C.A. 7th, 1927). To such a case the language in *Commissioner* v. *Proctor Shop, Inc.*, 82 F. 2d 792, 794 (C.C.A. 9th, 1936) would properly be applicable; but the use made of that language by the Tax Court in the present case (R. 80) and by the Circuit Court of Appeals (R. 99) is utterly unwarranted because of the fundamental difference between the situations presented.

[8] See dissenting opinion of Magruder, J. (R. 103).

stock (R. 79, 80, 98), or that the holders of the notes also continued to hold their remaining stock (R. 80, 98), or that a small amount rather than a large amount ever changed hands (R. 80, 96, 99), and upon the basis of such considerations arrive at the conclusion that for purposes of taxation the notes were not the evidences of indebtedness which for every other purpose in general law and ordinary business life they were.

D. *As to the right of the Petitioner to rearrange its affairs with frank regard to minimizing the incidence of taxation.*

In *Bullen* v. *Wisconsin*, 240 U. S. 625, 60 L. Ed. 830 (1916), this Court said,

> "We do not speak of evasion, because, when the law draws a line, a case is on one side of it or the other, and if on the safe side is none the worse legally that a party has availed himself to the full of what the law permits. When an act is condemned as an evasion, what is meant is that it is on the wrong side of the line indicated by the policy if not by the mere letter of the law." 240 U. S. p. 630–631, 60 L. Ed. p. 835.

The concern of the Tax Court and of the Circuit Court of Appeals with the Petitioner's so-called "tax motives" was improper under the language quoted above and, in effect if not in form, was a flat denial of the Petitioner's right to deduct the interest on notes outstanding if such notes were issued with tax objectives in mind.

Counsel have relied upon the famous words of Mr. Justice Holmes for many years. Constantly they have advised clients that they might so rearrange their affairs as to present the least exposure to taxation under the laws, provided only that in so doing their arrangements were genuine and durable and not false fronts for other underlying arrangements at variance or temporary devices like the scaffolding that surrounds a building (Cf. *Gregory* v. *Helvering*, 293 U. S. 465). The citizens of this Country are entitled to know from this Court whether that principle still prevails in its former integrity.

It is manifest that if the circumstance of "tax motives"

may be utilized by the courts in the manner in which it was utilized in the opinions below, the words of *Bullen* v. *Wisconsin* become simply a trap for the unwary.

We recognize what is said about the "policy, if not . . . the mere letter of the law." But the policy of a federal tax statute is to be found in the statute itself, possibly illuminated by its history, and not in the policy-making tendencies of judges. It is notable that in the decisions below there was not made even the faintest attempt to interpret the words of I.R.C. Section 23 (b) in the light of context or of other portions of the statute or of previous enactments or of legislative history.[9] Instead the words were ignored and the policy was summoned into existence out of the judicial imagination.

In this latter respect, the courts below have flown in the face of the admonitions against judicial legislation found in decisions of this Court and of the Circuit Courts of Appeals as well:

Crooks v. *Harrelson*, 282 U. S. 55 (1930), 75 L. Ed. 156, 175

Iselin v. *United States*, 270 U. S. 245, 251 (1926) 70 L. Ed. 566, 69-70

Western & Southern Life Ins. Co. v. *Huwe*, 116 F. 2d 1008, 1010 (C.C.A. 6th, 1941)

Forstman v. *Rogers*, 128 F. 2d 126, 129 (C.C.A. 3d, 1942)

Noteman v. *Welch*, 108 F. 2d 206, 208, 215 (C.C.A. 1st, 1939)

Mead Corporation v. *Commissioner*, 116 F. 2d 187, 191 (C.C.A. 3d, 1940).

E. *The inapplicability of Dobson* v. *Commissioner.*

---

[9] We are prepared to show that the history of the statute imparts to the words "all interest" additional force. Also that the Court's construction brings confusion into other branches of the tax statute. And see dissenting opinion of Magruder, J. (R. 105).

In *Dobson* v. *Commissioner*, 320 U. S. 489, 88 L. Ed. 179 (1943) this Court said,

> "It is contended that the applicable statutes and regulations properly interpreted forbid the method of calculation followed by the Tax Court. If this were true, the Tax Court's decision would not be 'in accordance with law' and the Court would be empowered to modify or reverse it. Whether it is true is a clear-cut question of law and is for decision by the courts. . . ." 320 U. S. p. ; 88 L. Ed. p. 182.

The case related to whether certain transactions in separate years, relating to the same subject matter, should be treated for tax accounting purposes as a single transaction or as a series of separate transactions. This Court held that the Tax Court's determination of this issue should stand because the issue presented essentially a question of fact. The decision accords new emphasis to the finality to which decisions of questions of fact by the Tax Court are entitled when supported by substantial evidence. But, as the above quotation shows, it does not impart immunity to errors of law committed by the Tax Court.

What constitutes sound accounting practice is an issue of fact. There is little law about accounting. If a man promises to pay money based on certain operating results, to be ascertained in accordance with sound accounting practice, the issue of how much is due from him would be almost completely a question of fact. But "indebtedness" and "interest" are very strongly legal conceptions. There is a great deal of law about them and it is far more likely that Congress used these words in the deduction section with reference to the common understanding of their meaning—than that it used them in some new and strange sense,[10] peculiarly related to taxation, which only "an administrative body having

[10] Cf. *Commissioner* v. *Raphael*, 133 F. 2d 442, 445 (C.C.A. 9th, 1943).

special competence to deal with the subject matter would have the insight to interpret and apply."[11]

In the present case, practically all material facts are stipulated. There is a clear, complete and unambiguous instrument to be analyzed and a direct and categorical provision of the statute to be construed and applied to it. There is no evidence or suggestion of the notes being a sham, or temporary expedient or instrumentality for accomplishing an entirely distinct purpose. Hence, no substantial issue of fact is presented upon which a finding supported by evidence would be final.[11] The only dispute of fact which the Tax Court opinion even contemplates is the issue made by the Tax Court with respect to "intent," which upon analysis is nothing but an improper concern with a question of "motive."

The meaning of the words in the deduction section; whether the deduction section is absolute or subject to the reading in of implied exceptions; whether the meaning of the section may be varied by applying a distinction between "loans" and "Capital investments"; whether the notes do or do not evidence debts; whether or not the annual sums agreed to be paid thereon to service the debts are payments of the type which the law knows as interest; whether a complete and unambiguous written instrument may be distorted from its true intendment by extrinsic evidence and discussions of "motive"; whether a confusion of "intent" and "motive" is erroneous and prejudicial; whether it may be held that every feature of an instrument is a permissible feature of a debt and yet that all features together make the instrument not a debt, notwithstanding that the central feature is an unqualified promise to pay a fixed sum at a fixed maturity; whether a purported statutory construction, implied in a decision, amounts practically to judicial legislation; whether a particular application of a statute would violate established canons of construction; all these are questions of law and not of fact and on each one of these the Tax Court (and the Cir-

[11] See dissenting opinion of Magruder, J. (R. 105-106).

cuit Court of Appeals) arrived at an erroneous conclusion or it could not have reached the result it did.

It follows that the use made of the *Dobson* case is in conflict with that decision and, as pointed out by the dissenting Judge [12] is a use which should not be made of it until explicitly authorized by this Court.

III. THE QUESTIONS OF LAW PRESENTED ARE OF IMPORTANCE AND SHOULD BE DECIDED BY THIS COURT.

A. *The issues are important in the administration of the revenue laws.*

Certiorari has often been granted for this reason and often in cases which were certainly of no wider interest or importance than the present case. There are now a large number of decisions of the Circuit Courts of Appeals and other Courts endeavoring to deal with the distinctions between indebtedness and stock in so-called borderline cases (many of which are made borderline cases only by the Courts' own gratuitous assumptions with respect to what rule they are administering). In the entire case literature upon this subject we have found no direct word from this Court.

The use of loose criteria, the straying away from respectful adherence to the text of the statutes, the assumption that unambiguous documents may be controlled by extrinsic evidence, the blurring of "intent" with "motive," the too wide assumption of latitude in searches for "substance" to replace "form," have resulted in a body of decisions which are difficult to reconcile and which afford no firm foundation for future conduct, either of taxpayers or of the Commissioner of Internal Revenue. They range from one extreme comprising a group of cases decided in favor of taxpayers, the soundness of some of which decisions [13] we frankly question, to extreme

---

[12] (R. 106).

[13] e.g. *Commissioner* v. *Proctor Shop*, 82 F. 2d 792 (C.C.A. 9th, 1936)

Helvering v. *Richmond F. & P. R. Co.*, 90 F. 2d 971, (C.C.A. 4th, 1937)

cases in favor of the Commissioner as exemplified in the present case.[14]

The rule to be applied in these cases ought to be settled and its boundaries defined by this Court. It is moreover necessary, if the case of *Dobson* v. *Commissioner* is not to create confusion in the law far greater than the compass of any addition which it has made to the law, that this Court pass upon its applicability in cases like the present, where the extent of genuine factual issues is almost zero and questions of law are presented by the handful.

B. *The issues are important to the security of commercial transactions.*

When after careful consideration the decision to issue these notes in exchange for stock was reached in the year 1939, the conclusion that interest thereon would be deductible was clearly warranted by the express language of the statute, which has not since changed, and by every decision which the industry of counsel could unearth.

It is natural and unavoidable that under pressures of taxation, people will seek to arrange their affairs to keep its incidence upon them at a minimum. Indeed, the complexity of tax laws, and the variety of circumstances under which they now impinge upon every move a man can make with respect to property have actually resulted in exalting the prediction of tax consequences above the exercise of normal good

---

Guaranty Savings & Loan Co., 14 BTA 72
Palmer, Stacy-Merrill, Inc., 39 BTA 636, Affmd. 111 F. 2d 809
Diamond Calk Horse Shoe Co. v. *United States*, D.C.D.Minn. 7/20/40, CCH Par. 9641, Appeal Dismissed on Stipulation 116 F. 2d 284
Meridian and Thirteenth Realty Co., 44 BTA 865
See Also *H. R. Demilt Co.*, 7 BTA 7

[14] It may also be of interest to examine *John Kelley Co.*, 1 T.C. 457; reversed in *Commissioner* v. *John Kelley Co.*, 146 F. 2d 466, (C.C.A. 7th, 1944), with respect to which we understand certiorari is being sought.

judgment as to business arrangements or dispositions to be made with respect to property.

No one concerned with corporate finance or with the settlement of the affairs of an individual can today give primary consideration to desired economic objectives. It is necessary to consider first what may be done without the incurring of tax consequences so heavy as to prohibit the pursuit of those objectives. If, upon top of this, one is obliged to wade through a welter of conflicting enunciations of principles by the various lower federal courts, without clear guidance from this Court, transactions are handicapped to a preposterous degree.

There is nothing to distinguish the present case from the Second Circuit case of *O.P.P. Holding Company*,[15] in real substance, except that the Talbot Mills notes bear a variable rate of interest. And yet, this provision for a variable rate of interest is indistinguishable in principle from the variable rate of interest provided for in the General-Mortgage Income 4½% Bonds of the Erie Railroad Company, issued in reorganization under court supervision, an excerpt from which is appended to this brief as Exhibit A. If the Erie Bond interest is not deductible in computing the taxable income of that Company, we think it may with complete safety be assumed that the consequences upon the revenue available for the Erie stock will obliterate assumptions legitimately made in formulating the terms of the Erie reorganization.

It is our contention that the decisions below display upon their face that they are not founded upon the words of the tax statute but upon judicial notions of what would be a wise incidence of legislative policy upon each particular case as it arises. The uncertainties to be injected into the guiding of important matters in the course of ordinary commercial affairs, by allowing such a judicial approach to stand uncorrected, calls, we submit, for the interposition of this Court.

C. *The issues presented are of importance with respect to the judicial process itself.*

Many a decision, deemed erroneous by unsuccessful

[15] 76 F. 2d 11 (C.C.A. 2nd, 1935)

counsel, has been none the worse for that and has presented no issue of public importance with respect to the judicial technique. This case, we submit, stands upon another footing.

It seems impossible, reading the majority decision in the Circuit Court of Appeals and the Tax Court decision, to avoid the conclusion that these tribunals in effect legislated against the Petitioner because of the belief that the Petitioner had substituted notes for stock to obtain a tax benefit to it.[16] Yet the Petitioner was thoroughly entitled to seek this result, in reliance upon what was said by this Court in *Bullen* v. *Wisconsin* and it is common knowledge that everyone does it whenever feasible.

The Petitioner went about the matter openly, issued notes that were absolutely genuine and vitiated by no secret underlying arrangement, incurred the heavy responsibility of facing a problem of refinancing at maturity and incurred a fixed obligation to pay at least [redacted] per cent interest in any event and an equally absolute obligation to pay as much more as might be determined by application of the interest formula. No issue of sham, temporary device or the like was or could have been presented.

Nevertheless, using judicial techniques which are appropriate and permissible only where substantial issues of fact of the type last-mentioned are presented, the Courts in effect denied the reality of what the Petitioner had really done. In so doing they viewed as material for that purpose the "tax motive," the fact that noteholders were also stockholders, the fact that there was but few stockholders, the fact that these persons were related by blood or marriage and other like circumstances having nothing to do with the meaning and legal intendment of the Petitioner's [redacted] contract.

Is there one law for corporations with 15 stockholders and another law for corporations with 15,000 stockholders?

Is there one law for corporations whose security holders

---

[16] See, similarly, *Commissioner* v. *John Kelley Company*, 146 F. 2d 466, 468 towards the end of the page.

are related and another law for corporations whose security holders are unrelated?

Is there one law for the Erie Railroad and another law for the Talbot Mills?

May the emphatic words of Congress be disregarded and policies legislated in their stead by the Courts?

Are citizens to be told by this Court that they may rearrange their affairs with a view to the incidence of taxation and told by a Judge of the Circuit Court that if they do he will find a way around it?

May a case with stipulated facts, with an unambiguous instrument to construe, and a statute to be interpreted and applied, be decided on the basis of the sort of extrinsic considerations which would properly be pertinent only to cases of alleged sham, temporary expedients, devices for unrelated ends or manifest ambiguities?

May Tax Court decisions in a case, involving fundamentally only issues of law, find shelter under the *Dobson* case by stretching the conception of what is "fact" to cover them?

Was not the Petitioner clearly entitled to a judgment operating upon principles of law as exemplified by the dissenting opinion in the Circuit Court of Appeals?

And are not these issues of sufficient general importance to receive the attention of this Court?

Respectfully submitted,

MELVILLE F. WESTON,
Counsel for Petitioner,
TALBOT MILLS.

POWERS & HALL
Of Counsel.

EXHIBIT A

Excerpt from Erie Railroad Company 4½% Income Bond Series A, due January 1, 2015

". . . to pay interest on said sum from the date hereof until

the payment of said principal sum at the rate of four and one-half per cent. (4½%) per annum, beginning April 1, 1942, on April 1 of each year thereafter, to and including April 1, 2014, and on January 1, 2015 (in each instance through the December 31 next preceding), and to pay an amount equal to interest at such rate from January 1, 1940, to the date hereof, *but, except as otherwise provided herein or in the Indenture hereinafter mentioned, only if and to the extent that the amounts applicable thereto under the provisions of the Indenture are sufficient to make such interest payments* and until the maturity of this Bond only upon presentation and surrender of the appropriate coupons as provided in the Indenture. *Unpaid interest will accumulate* [1] *to an amount not exceeding prior to maturity (exclusive of interest earned as provided in the Indenture but unpaid) 13½% of the principal hereof at any one time and such accumulated interest will be payable thereafter if earned as provided in the Indenture or, in any event, at the maturity of this Bond whether by declaration or otherwise.*" (Italics supplied)

Provisions of Article 5 of the mortgage indenture, too lengthy to quote herein, deal with the determination of "available net income," provide for numerous deductions therefrom for various purposes and state that "any then remaining available net income shall be applied to the payment of interest on the bonds." Other lengthy provisions may be summarized as providing that interest for each year shall accrue and become owing as a debt only if and to the extent that the amounts applicable to the payment thereof, under the provisions just mentioned above, shall suffice therefor. The provisions are elaborate and include other restrictions or qualifications of the obligation.

---

[1] It will be noted that only three years' unearned interest becomes unqualifiedly payable out of 74 years that the bond has to run to maturity.

FILE COPY

Office - Supreme Court, U. S.
FILED
SEP 24 1945
CHARLES ELMORE CROPLEY
CLERK

In the Supreme Court of the United States

October Term 1945
No. 47

TALBOT MILLS, *Petitioner*

v.

COMMISSIONER OF INTERNAL REVENUE

UPON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIRST CIRCUIT

BRIEF FOR THE PETITIONER

MELVILLE F. WESTON,
Counsel for Petitioner.
TALBOT MILLS.

POWERS & HALL
Of Counsel.

INDEX

	Page
Opinions Below	1
Jurisdiction	1–2
Statement of the Case	2–5
Specification of Errors	5–8
Statute Involved	8
Summary of Argument	8–10
Argument	10–43
1. All interest is deductible under the statute, not just some interest or interest on just some types of indebtedness	10–13
2. The words "indebtedness" and "interest" were used in the statute in their common and ordinary meaning, as well established in general law. Petitioner's notes evidenced such indebtedness and provided for such interest	13–19
3. Interest is still interest, notwithstanding it be at a sliding scale, or be otherwise qualified, so long as it is the compensation for the forbearance of a debt	19–22
4. The Courts below had no right to regard "evidence aliunde the contract" or apply factual tests applicable only in cases of "sham" and the like	22–27
5. The Petitioner had a right to rearrange its affairs with frank regard to minimizing the incidence of taxation	27–30

6. The decisions below are pure "judicial legislation," neither permissible nor even wise 30–38

7. If there is any doubt about the meaning of the statute, it is the kind of doubt which should be resolved in the taxpayer's favor 39–40

8. The decisions below are not sustainable upon the basis of *Dobson v. Commissioner* 40–43

APPENDIX A 44–50

APPENDIX B 51–53

APPENDIX C 54–56

APPENDIX D 57

TABLE OF CASES CITED

	Page
Addison v. *Holly Hill Fruit Products*, 322 U.S. 607, 617, 88 L. Ed., 1488, 1496	31
Antietam Hotel Corporation v. *Commissioner*, 123 F. 2d 274, 278 (C.C.A. 4th, 1941)	45
Arthur R. Jones Syndicate v. *Commissioner*, 23 F. 2d 833, 834 (C.C.A. 7th, 1927)	7, 23, 25
Austin v. *United States*, 28 F. 2d 677 (C.C.A. 5th, 1928)	20
Boston Consolidated Gas Co. v. *Commissioner*, 128 F. 2d 473, 476 (C.C.A. 1st, 1942)	46
Bowers v. *New York & A. Lighterage Co.*, 273 U.S. 346, 350 (1927)	44
Brown v. *J. C. Shaffer Grain Co.*, 15 F. 2d 514 (C.C.A. 1st, 1926)	22
Brown-Rogers-Dixson Co. v. *Commissioner*, 122 F. 2d 347 (C.C.A. 4th, 1941)	26
Bullen v. *Wisconsin*, 240 U.S. 625, 630–631, 60 L. Ed. 830, 835 (1916)	7, 27, 28, 30
Coleman v. *United States*, 37 F. Supp. 273, 277 (Ct. Cl. 1941)	44
Commissioner v. *Coastwise Transportation Corp.*, 71 F. 2d 104, 105 (C.C.A. 1st, 1934)	22
Commissioner v. *H. P. Hood & Sons*, 141 F. 2d 467 (C.C.A. 1st, 1944)	16, 21
Commissioner v. *Hopkinson*, 126 F. 2d 406, 411, (C.C.A. 2d, 1942)	45

Commissioner v. *John Kelley Co.*, 146 F. 2d 466, 468 (C.C.A. 7th, 1944) 28

Commissioner v. *National Grange Mutual Liability Co.*, 80 F. 2d 316 (C.C.A. 1st, 1935) 16

Commissioner v. *O.P.P. Holding Corporation*, 76 F. 2d 14 (C.C.A. 2nd, 1935) 16, 21

Commissioner v. *Proctor Shop Inc.*, 82 F. 2d 792, 794 (C.C.A. 9th, 1936) 30 BTA 721, 725 ..... 25, 26

Commissioner v. *Rabenold*, 108 F. 2d 639, 640 (C.C.A. 2d, 1940) 44

Commissioner v. *Raphael*, 133 F. 2d 442, 445 (C.C.A. 9th, 1943) 41

Commissioner v. *Schmoll Fils Asso.*, 110 F. 2d 611 (C.C.A. 2nd, 1940) 26

Corporation of America v. *McLaughlin*, 100 F. 2d 72, 74 (C.C.A. 9th, 1938) 44

Crooks v. *Harrelson*, 282, U.S. 55, 60, 61, 75, L. Ed. 156, 175 (1930) 6, 31 44

Deputy v. *Dupont*, 308, U.S. 488, 493, 497, 498, 84 L. Ed. 416, 421, 424, (1940) .. 6, 13, 14, 15, 18, 36, 45, 48

Diamond Calk Horse Shoe Co. v. *United States*, D.C.D. Minn 7/20/40, CCH Par. 9641, Appeal Dismissed on Stipulation 116 F. 2d 284 (C.C.A. 8th, 1940) 26

Dobson v. *Commissioner*, 320 U.S. 489, 492, 88 L. Ed. 248, 251, rehearing denied, 321 U.S. 231; 88 L. Ed. 691 (1943) 5, 8, 10, 20, 40, 43

Equitable Life Assurance Society v. *Commissioner*, 321 U.S. 560, 88 L. Ed. 927 (1944) 13, 14, 45, 49

Feitler v. *Harrison*, 126 F. 2d 449, 451 (C.C.A. 7th, 1942) 44

Forstman v. *Rogers*, 128 F. 2d 126, 129 (C.C.A. 3d, 1942) 31

Frost Lumber Industries v. *Commissioner*, 128 F. 2d 693, 694 (C.C.A. 5th, 1942) 44

Gregory v. *Helvering*, 293 U.S. 465 (1935) 7, 24, 27

Gould v. *Gould* 245 U.S. 151, 153, 62 L. Ed. 211, 213 (1917) 7, 39, 40, 44

Haffenreffer Brewing Co. v. *Commissioner*, 116 F. 2d 465, 468 (C.C.A. 1st, 1940) 16, 26

Hamilton v. *Liverpool, etc. Ins. Co.*, 136 U.S. 242, 34 L. Ed. 419 (1890) 6, 22

Harwick v. *Commissioner*, 133 F. 2d 732, 735 (C.C.A. 8th, 1943) 45

Hassett v. *Welch*, 303 U.S. 303, 314 (1938) 44

Hellmich v. *Hellman*, 276 U.S. 237, 72 L. Ed. 546, 48 S. Ct. 244, 56 A.L.R. 379 47

Helvering v. *Alabama A. Limestone Co.*, 315 U.S. 179 (1942) pp. 184–5 "Transitory phases" 24

Helvering v. *Cannon Valley Milling Co.*, 129 F. 2d 642, 647 (C.C.A. 8th, 1942) 46

Helvering v. *Northwest Steel Rolling Mills*, 311 U.S. 45 (1940) 45, 48

Helvering v. *Ohio Leather Co.*, 317 U.S. 102 (1942) 45, 49

Helvering v. *Richmond F. & P. R. Co.*, 90 F. 2d 971 (C.C.A. 4th, 1937) 26

Iselin v. *United States*, 270 U.S. 245, 251; 70 L. Ed. 566, 69–70 (1926) 6, 31

Kena, Inc., 41 B.T.A. 217 20

S. S. Kresge Co. v. *Sears*, 87 F. 2d 135, 138, 140 (C.C.A. 1st, 1936) 22

S. H. Kress Co. v. *Fisher*, 65 F. 2d 682, 683 (C.C.A. 4th, 1933) 22

Lydia E. Pinkham Medicine Co. v. *Gove*, 303 Mass., 1, 12 (1939) 24

Maillard v. *Lawrence*, 16 How (U.S.) 251, 261; 14 L. Ed. 925, 930 48

Maloney v. *Portland Associates*, 109 F. 2d 124 (C.C.A. 9th, 1940) 45

Mayer v. *Reinecke*, 28 F. Supp. 334, 339–40. (D.C.N.D. Ill., 1939) 44

Mead Corporation v. *Commissioner*, 116 F. 2d 187, 191 (C.C.A. 3d, 1940) 31

Meehan v. *Valentine*, 145 U.S. 611, 624; 36 L. Ed. 835, 841 (1892) 6, 19

Mérinos Vtesca Y. Compania v. *Pan American P. & T. Co.*, 83 F. 2d, 240, 242 (C.C.A. 2d, 1936) .. 22

National Investor's Corporation v. *Hoey*, 144 F. 2d 466, 468 (C.C.A. 2d 1944) 23

National Surety Corp. v. *Ellison*, 88 F. 2d 399, 403 (C.C.A. 8th, 1937) 22

New Colonial Ice Co. v. *Helvering*, 292 U.S. 435, 440; 78 L. Ed. 1348, 1352, 54 S. Ct. 788 (1934) 45, 47, 48

Noteman v. *Welch*, 108 F. 2d 206, 208, 213, 215 (C.C.A. 1st, 1939) 13, 14, 31

Old Colony Railroad Co. v. *Commissioner*, 284 U.S. 552, 560–2, 76, L. Ed. 484, 489, (1932) 13, 14, 44, 45

Pacific Southwest Realty Co. v. *Commissioner*, 45 BTA 126, CCH Dec. 12, 127, affd. 128 F. 2d 815 (C.C.A. 9th, 1942) 26

Palmer, Stacy-Merrill, Inc., 39 BTA 636, Affmd. 111 F. 2d 809 (C.C.A. 9th, 1940) 26

Parisian Inc., 46 B.T.A. 1279, (CCH Dec. 12, 139–B, aff'd. 131 F. 2d 394 (C.C.A. 5th, 1942) 26

Partee v. *Commissioner*, 114 F. 2d 716, 719 (C.C.A. 6th, 1940) 44

Penn Co. for Insurances etc. v. *United States*, 39 F. Supp. 1019, 1022 (D.C.E.D. Pa. 1941) 44

Plimpton v. *Commissioner of Internal Revenue*, 135 F. 2d 482, 486 (C.C.A. 1st, 1943) 33

Trust u/w Bingham v. *Commission of Internal Revenue*, U.S. , 89 L. Ed. 1191 (1945) 42, 43

Uhl Estate Co. v. *Commissioner*, 116 F. 2d 403 (C.C.A. 9th, 1940) 45

Union State Bank & Tr. Co. v. *Northwestern Life Ins. Co.*, 55 F. 2d 1070, 1072 (C.C.A. 5th 1932) .. 22

United States v. *Classic*, 313 U.S. 299, 316, 85 L. Ed. 1368, 1378, 61 S. Ct. 1031 31

United States v. *Motsinger*, 123 F. 2d 585, 589 (C.C.A. 4th, 1941) 44

Western & Southern Life Ins. Co. v. *Huwe*, 116 F. 2d 1008, 1010 (C.C.A. 6th, 1941) 32

White v. *Aronson*, 302 U.S. 16, 20 (1937) 44

White v. *United States*, 305 U.S. 281 (1938) 45, 47

Wiggin Terminals v. *United States*, 36 F. 2d 893 (C.C.A. 1st, 1929) 7, 23, 25

Woodford Realty Co. v. *Rose*, 286 U.S. 319, 76 L. Ed. 1128 (1932) 39, 45, 46

REFERENCES TO STATUTES

	Page
Revenue Act, 1916, Section 5 (a)	54
Revenue Act 1916, Section 12 (a) Third	11, 12, 54
Revenue Act 1918, Section 23 (b); Section 214 (a) (2); Section 234 (a) (2)	11, 12, 54, 55
Revenue Act 1921, Section 214 (a) (2); Section 234 (a) (2)	11
Revenue Act 1924, Section 214 (a) (2); Section 234 (a) (2)	11
Revenue Act 1926, Section 214 (a) (2); Section 234 (a) (2)	11
Revenue Act 1928, Section 23 (b)	11
Revenue Act 1932, Section 23 (b)	11
Revenue Act 1934, Section 23 (b)	11
Internal Revenue Code, Sections 13 (b); 15 (b)	49
Internal Revenue Code, Section 23 (a) (1) (A)	20
Internal Revenue Code, Section 23 (a) (2)	42
Internal Revenue Code, Section 23 (b)	1, 4, 5, 6, 8, 11, 28, 35
Internal Revenue Code, Section 23 (g)	36
Internal Revenue Code, Section 23 (g) (3)	37
Internal Revenue Code, Section 23 (k)	36
Internal Revenue Code, Section 23 (k) (3)	37
Internal Revenue Code, Section 23 (z)	37
Internal Revenue Code, Section 23 (z) (2) (A) (i)	37

Internal Revenue Code, Section 23 (z) (2) (A) (ii) ... 37
Internal Revenue Code, Section 27 37
Internal Revenue Code, Section 27 (a) (4) 37
Internal Revenue Code, Section 27 (b) (1) 37
Internal Revenue Code, Section 117 (i) 37
Internal Revenue Code, Section 125 38
Internal Revenue Code, Section 125 (d) 37
Internal Revenue Code, Section 322 42
Internal Revenue Code, Section 332 38
Internal Revenue Code, Section 502 38
Internal Revenue Code, Section 718 38
Internal Revenue Code, Section 719 38
Internal Revenue Code, Section 3772 42
Judicial Code, Section 24, amended, U.S. Code, Section 41 (5) (20) 42
Judicial Code, Section 145, U.S. Code, Section 250 (1) 42
Judicial Code, Section 240 (a), as amended by the Act of February 13, 1925 (U.S. Code, Title 28, Section 347 (a)) 1
Regulations 101, Article 23 (b) — 1 12
Regulations 111, Section 29.23 (b) — 1 12

In the Supreme Court of the United States.

October Term 1935
No. 47

TALBOT MILLS, *Petitioner*

v.

COMMISSIONER OF INTERNAL REVENUE

BRIEF FOR THE PETITIONER

Talbot Mills, a Massachusetts corporation, respectfully submits this brief upon the merits in the above entitled cause.

OPINIONS BELOW

The opinion of the Circuit Court of Appeals (R. 93) is reported in 146 F. 2d, 809. The opinion of the Tax Court (R. 73–81) is reported in 3 T.C. 95.

JURISDICTION

A. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code as amended by the Act of February 13, 1925 (U. S. Code, Title 28, Section 347 (a)).

B. The case involves the construction and application of Internal Revenue Code, Section 23 (b), providing that in

computing net income there shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness (with an exception not material). This deduction has been denied to the Petitioner in violation of applicable principles of law, as hereinafter set forth. That the issues are substantial may be assumed in view of the granting of the writ.

C. The decision of the Circuit Court of Appeals was entered December 22, 1944. Certiorari was applied for March 22, 1945 and granted April 30, 1945. (R. 104)

STATEMENT OF THE CASE

The Respondent determined a deficiency in Petitioner's Income and Excess Profits Tax liability for the Petitioner's taxable (fiscal) year ended September 30, 1940 (R. 57–59). Petitioner applied to the Tax Court of the United States for a redetermination of the deficiency (R. 3–6). The Tax Court sustained the Respondent's determination of a deficiency (R. 73–81, 85). Petitioner duly sought review by the United States Circuit Court of Appeals for the First Circuit (R. 86–7). The Circuit Court of Appeals, one judge dissenting, affirmed the decision of the Tax Court (R. 93–106).

The deficiency was based upon the disallowance by the Respondent of $40,000 which the Petitioner had deducted as interest upon its return (R. 59, 73, 93–94). This was interest on the Petitioner's issue of registered notes, outstanding in the aggregate face value of $400,000 (R. 74, 95). It was stipulated that the item of $40,000 was properly accrued for and on account of the taxable year in question (R. 14–15). The issue was whether such item, so accrued, constituted interest deductible within the meaning of Section 23 (b) of the Internal Revenue Code (R. 59, 3–6, 14–15, 73, 78, 97).

The full text of a specimen of Petitioner's notes appears at pages 19–25 of the printed record. Specific pertinent provisions may be mentioned as follows:

Their central and dominant feature was an unqualified promise to pay to each payee a fixed sum of dollars at a definite maturity, slightly over twenty-five (25) years after the date of issue (R. 19, 74, 95). The Petitioner further promised to pay interest upon such fixed amount of principal at not less than 2% nor more than 10% in each year and, within that range, at the rate (to the nearest 1/4%) which a sum equal to two-thirds (2/3) of the Petitioner's net earnings for the fiscal year would represent upon an assumed principal of $400,000 (R. 20, 75, 95).

Interest for the year ended September 30, 1940, was determined at the rate of 10 per cent in accordance with these provisions (R. 48, 78, 96–97) being the $40,000 the deduction whereof is in question (R. 78, 93).

The notes further provided for the payment of interest under certain circumstances at the flat rate of 6% (R. 20, 21, 22); the power of the Petitioner to defer payment of interest, only as its Directors in good faith should determine to be necessary, and in no event beyond December 1, 1964 (R. 20); acceleration of maturity in event of bankruptcy and the like (R. 21); the power of the Petitioner to effect subordinations to other obligations maturing not later than December 1, 1964 — there was no general subordination, only a power to make, and under proper conditions terminate, subordinations — (R. 21–22); the power to call and retire the notes (R. 22–23); the power of three-fifths (3/5) of the noteholders to consent to changes, not affecting the fundamental obligations (R. 23–24); and certain provisions affecting transferability (R. 24).

The recapitalization, in the course of which the notes were issued, is set out in the record (R. 10–13; 18–19; 26–28; 36–39; 41–45).

Certain specific subordinations, since terminated, are set out in the record (R. 14; 29–35; 44–45; 46–47).

Nowhere in the Commissioner's pleadings or in the findings of the Tax Court or in the opinion of the Circuit Court of Appeals can be found any suggestion that the promises embodied in the Petitioner's notes were not genuine, or not made in good faith, or not intended to be performed in accordance with their terms. There was no suggestion that the notes were a "sham," or that they did not embody the real understanding of the parties to the transaction.[1]

Nevertheless, the Tax Court held that the notes did not create any "proper indebtedness," that they "were more in the nature of a capital investment than a loan to the corporation," and that the payments made as interest were not deductible under Section 23 (b) of the Internal Revenue Code (R. 81).

The Tax Court based its conclusion upon the circumstances:—(a) that the notes bore a "variable rate of interest computed with reference to profits" (R. 79); (b) that they were "issued in exchange for stock of the issuing corporation" (R. 79, 80); (c) that the notes provided under certain circumstances that "the payment of interest might be deferred" (R. 79); and (d) that the "factor of tax avoidance" was a "substantial purpose motivating the transaction" (R. 80). It asserted that the "cumulation of these various restrictive features . . . tends to cast doubt on the real nature of the instant transaction" (R. 80); that therefore the intent of the parties must be sought, with evidence *aliunde* the contract admissible (R. 80); and that "what the parties really intended to create was a security retaining the profit-sharing advantage of stock, leaving intact their voice in the management,[2] but extending a tax advantage to the corporation not possible in stock" (R. 80–81).

---

[1] See specifically the dissenting opinion (R. 103).

[2] Ignoring the obvious fact that this right was attached only to the remaining outstanding stock, not to the notes.

The Circuit Court of Appeals based its decision upon the circumstances that the notes were issued in exchange for stock (R. 98, 101); that the rate of interest was variable (R. 99–100); that the notes were capable of being subordinated to the claims of other creditors (R. 101); that the payment of interest could be deferred (R. 100); and that Petitioner had "tax avoidance" as a motive in the issuance of notes in exchange for stock (R. 98–99). It also held that the meaning of the notes was governed by extrinsic evidence (R. 98, 99). In addition, the Court relied upon *Dobson* v. *Commissioner*, 320 U. S. 489 (1943) as requiring that the Tax Court be upheld.

Both the Tax Court and the Circuit Court of Appeals also apparently regarded as material the facts that the Petitioner had but few stockholders, who were related by blood or marriage; that the noteholders also continued to hold stock; and that but few of the notes had been transferred to date (R. 74, 76, 80, 94, 98, 99).

The Tax Court and the Circuit Court of Appeals both ignored the strong categorical language of I.R.C. Section 23 (b) providing that deduction shall be allowed for "*all interest* paid or accrued within the taxable year on indebtedness" (italics added). Both paid as little regard as possible to the fundamental fact that the notes embodied a firm promise to pay a fixed sum of money at a fixed maturity, which, at least for every purpose other than taxation, would unquestionably constitute an indebtedness. Both concerned themselves with "tax motives." The error of both decisions is made sharply clear by the contrast presented by the dissenting opinion of Judge Magruder (R. 101).

SPECIFICATION OF ERRORS

The Petitioner specifies the following errors committed by the Circuit Court of Appeals.

1. The Court erred in holding that the sums accrued as interest upon the Petitioner's outstanding registered notes were not deductible as interest under Internal Revenue Code, Section 23 (b).

2. The Court erred in applying a rule which makes only some interest upon some indebtedness deductible, whereas the statute grants a deduction to *all* interest upon indebtedness. Herein of "judicial legislation." *Crooks* v. *Harrelson*, 282 U.S. 55, 75 L. Ed. 156 (1930); *Iselin* v. *United States*, 270 U.S. 245, 70 L. Ed. 566 (1926).

3. The Court erred in failing to construe the term "interest" in said statute as including the amounts accrued upon the Petitioner's registered notes.

4. The Court erred in failing to attribute to the terms "interest" and "indebtedness" in said statute their plain and natural meaning as reflected in common usage and general law. *Deputy* v. *DuPont*, 308 U.S. 488, 84 L. Ed. 416 (1940).

5. The Court erred in failing to construe the term "indebtedness" in the statute as including the principal obligation created by the Petitioner's registered notes.

6. The Court erred in construing the statute by the application of an untenable distinction between "loans" and "capital investments."

7. The Court erred in using extrinsic evidence to control the meaning of Petitioner's notes. *Hamilton* v. *Liverpool, etc. Ins. Co.*, 136 U.S. 242, 34 L. Ed. 419 (1890).

8. The Court erred in applying criteria, applicable only in cases of alleged sham and the like, to a case in which there was in fact no question and no issue but that the Petitioner's notes were genuine and intended to be enforced according to their terms.

9. The Court erred in holding in effect that interest, to be deductible under the statute, must not be at a rate measured with reference to profits. *Meehan* v. *Valentine*, 145 U.S. 611, 36 L. Ed. 835, (1892).

10. The Court erred in regarding and making the basis of its decision such factors as:

(a) That the Petitioner's notes were issued in exchange for stock;

(b) That the Petitioner's notes provided for a variable rate of interest;

(c) That the Petitioner's notes brought no new capital into the corporation;

(d) That the Petitioner's notes were capable of being subordinated to claims of other creditors;

(e) That under the provisions of Petitioner's notes payments of interest might be deferred;

(f) That Petitioner's notes were held by persons who were also stockholders;

(g) That the holders of Petitioner's notes were related by blood or marriage.

11. The Court erred in regarding and making the basis of its decision, the circumstance that a tax advantage was a principal purpose of the recapitalization in which Petitioner's notes were issued. *Bullen* v. *Wisconsin*, 240 U.S. 625, 60 L. Ed. 830 (1916).

12. The Court erred in treating the indebtedness actually created by the Petitioner's notes as if it were "form" instead of "substance" in a case in which there was neither evidence nor suggestion of sham or unreality, or of a temporary expedient (Cf. *Gregory* v. *Helvering*, 293 U.S. 465), or of a transaction for security only or to achieve some other unrelated end (Cf. *Wiggin Terminals* v. *United States*, 36 F. 2d 893; *Arthur R. Jones Syndicate* v. *Commissioner*, 23 F. 2d 833).

13. The Court erred in failing to apply the rule of construing tax statutes in favor of the taxpayer, *Gould* v. *Gould*, 245 U.S. 151, 62 L. Ed. 211 (1917), in a case where the application of such rule merely required giving to the language of the statute its plain, straightforward meaning.

14. The Court erred in applying the rule of *Dobson* v. *Commissioner*, 320 U.S. 489, in a case in which the fundamental issues involved were issues of law and not of fact.

STATUTE INVOLVED

The statute under which the deduction is claimed is as follows:

INTERNAL REVENUE CODE

Sec. 23. Deductions From Gross Income

In computing net income there shall be allowed as deductions:

(b) *Interest.* — All interest paid or accrued within the taxable year on indebtedness, except . . ." (Exception not material)

SUMMARY OF ARGUMENT

The statute is absolute and general in allowing *all* interest upon indebtedness to be deducted with but a single (not here relevant) exception. It has been so for twenty-seven years. No regulation has even attempted to engraft exceptions upon it. Its terms are to be given their common and ordinary meaning. The plain and straight forward generality of the statute should be adhered to, as against the reading in of exceptions which have no textual support. At least to this limited degree, any "doubts" should be "resolved in the taxpayer's favor."

"Indebtedness" simply means the owing of money. "Interest" simply means the agreed (or otherwise lawfully determined) compensation for the delay in paying off the debt. The debt is the basic thing. Interest is the incident of debt. Given a debt, interest may take any lawful form.

By these criteria, the taxpayer's notes are to be judged. Their character does not turn upon whether their holders are

kin by blood or marriage or are also stockholders in the debtor corporation. It is not altered by their containing lawful agreements as to the manner in which the holders will enforce or refrain from enforcing the debts. It is not dependent upon an alleged distinction between "investments" and "loans," nowhere suggested by the text of the statute.

These notes stand in their own right. Their sole purpose is to evidence the indebtedness which they embody. There is no evidence that they were merely instrumentalities to accomplish some different ends. There is no evidence that they were unreal — a "sham" — with the realities governed by some other inconsistent arrangement. There is no evidence that they were a temporary expedient, not meant to last and govern according to their terms. There is not even such a claim advanced. Hence they are to be judged by their actual character as disclosed upon the face of an unambiguous document.

So, judged, they are debts and can be nothing but debts. They promise to pay a fixed sum at a fixed maturity, and meanwhile to pay interest thereon. Interest is at a sliding scale, having reference to earnings, but it is none the less interest, i.e., compensation for the detention of the principal. Year by year the rate becomes fixed and the obligation becomes absolute; payment must eventually be made. Our agreement merely allows the owners of the corporate equity to get something whenever the earnings are more than sufficient to pay the 2% minimum on the notes. In exchange for this consideration, the noteholders are allowed a possible, correspondingly high, maximum rate of 10%.

The Courts below have utterly confused "motive" and "intent." The result — and the manifest purpose — is to deny the deduction because one *motive* of the recapitalization was to give the petitioner a more favorable tax position. This result, which could not properly be reached by direction, is equally improper when reached by indirection. The Courts below

first treat an obviously unambiguous instrument as if it were ambiguous and then resolve the alleged ambiguity by talk about "intent" which upon analysis is nothing but "motive." The Tax Court is so far away from the statute that it never even quotes the statute in its opinion. The Circuit Court of Appeals mentions the statute but makes not the faintest effort to deal with its categorical language.

Citizens have a right to arrange their affairs with a view to the minimum incidence of taxation, so long as they do it openly and squarely, without sham or the adoption of meaningless temporary expedients. It is the duty of the courts to refrain from "judicial legislation" and to regard the direct, clear language of the statute. And the *Dobson* decision is not a formula for altering the law under the guise of a "finding of fact."

The Petitioner protests against a judicial technique which disregards the express language of the statute, treats a genuine business arrangement as if it were a sham although no issue of sham exists, disregards applicable rules for the construction of statutes, in effect asserts the existence of a common law of taxation with a right to control and alter the statutes enacted by Congress, discriminates against the Petitioner because it is owned by a few people instead of by many, and in general deprives it and all others similarly situated of their clear rights under the law. The issue is not whether it is wise legislation to allow the deduction of this particular interest. Congress has allowed the deduction of *all* interest. If this is unwise the remedy lies with Congress. The deduction should be allowed.

ARGUMENT

I. All Interest is Deductible Under the Statute, not Just Some Interest or Interest on Just Some Types of Indebtedness.

The Statute, I.R.C. § 23 provides

"In computing net income there shall be allowed as deductions: . . .

(b) INTEREST. — *All interest paid or accrued within the taxable year on indebtedness*, . . ."

We call attention to the word "all," and ask . . . does it mean all or does it not? In the statute itself, there is found a single express exception, not here relevant.[2] There once were elaborate limitations upon the deduction of interest by corporations (Revenue Act, 1916, § 12 (a) Third) but these were all swept away in 1918, when corporations were given the same broad deduction for interest which individuals had already enjoyed.[3]

From 1918 forth, Section 23 (b) has stood unchanged, so far as concerns our case.[4] For twenty-five years its form has been as nearly categorical and all-inclusive as could well be conceived. The words are "all interest . . . on indebtedness." Congress could hardly have made the language stronger —

---

[2] The statute continues: — "except on indebtedness incurred or continued to purchase or carry obligations (other than obligations of the United States issued after September 24, 1917, and originally subscribed for by the taxpayer) the interest upon which is wholly exempt from the taxes imposed by this Chapter."

[3] See Appendix C., p. 54 of this brief, where the liberalization of the deduction afforded by the Revenue Act of 1918 is set forth.

[4] Rev. Act 1934 § 23 (b) is identical, and all changes in prior acts since 1918 have affected only the exception relating to money borrowed to purchase or carry non-taxable securities or like property. Rev. Acts: 1932, § 23 (b); 1928 § 23 (b); 1926 § 214 (a) (2), § 234 (a) (2); 1924, § 214 (a) (2), § 234 (a) (2); 1921, § 214 (a) (2), §234 (a) (2); 1918, §214 (a) (2), § 234 (a) (2).

unless, indeed, it is to be held the duty of the legislative, when trying to attain inclusiveness, to clutter up statutes with such expressions as "of all kinds, manners and descriptions whatsoever."

The presence of a single (not here relevant) exception shows that Congress has adverted to the possibility of exceptions and has made but one; and the radical destruction in 1918 of the limitations upon corporate deductions of interest found in the 1916 Act, demonstrates an affirmative purpose that the deduction be sweeping and general.

In his published Regulations, the Commissioner has provided, in part and so far as possibly relevant

> "INTEREST. —*Interest paid or accrued within the year on indebtedness may be deducted from gross income* . . . . .
>
> *"Interest calculated for cost-keeping or other purposes on account of capital or surplus invested in the business which does not represent a charge arising under an interest-bearing obligation, is not an allowable deduction from gross income. Interest paid by a corporation on scrip dividends is an allowable deduction. So-called interest on preferred stock, which is in reality a dividend thereon, cannot be deducted in computing net income."* Regulations 101, Art. 23 (b) —1.

The regulation was the same when our notes were issued, and in all relevant respects stands unchanged today (Regulation 111, Sec. 29.23 (b)–1). It contains no intimation of any official administrative purpose to engraft exceptions or limitations upon the general and categorical deduction granted by the statute.

By implication (from the negative proposition asserted at the beginning of the last quoted paragraph) the Commissioner recognizes that even interest on "capital or surplus invested in the business" is an allowable deduction whenever it is "a

charge arising under an interest-bearing obligation." This is highly incompatible with the Tax Court's notion that an interest-bearing obligation is not indebtedness when it is "more in the nature of a capital investment than a loan." T.C. Opinion, (R. 81)

The regulation provides that "so-called interest *on preferred stock*, which is really a dividend thereon" is not a deduction, a conclusion with which no one will disagree, but the regulation nowhere attempts to say that some types of indebtedness shall be treated as if they were preferred stock for the purposes of the deduction, which is what he is now asserting without foundation in either statute or regulation.[5]

2. THE WORDS "INDEBTEDNESS" AND "INTEREST" WERE USED IN THE STATUTE IN THEIR COMMON AND ORDINARY MEANING, AS WELL ESTABLISHED IN GENERAL LAW. PETITIONER'S NOTES EVIDENCED SUCH INDEBTEDNESS AND PROVIDED FOR SUCH INTEREST.

In *Deputy* v. *Dupont*, 308 U.S. 488, 493, 84 L.Ed. 416, 421 (1940), this Court said,[6]

> "And when it comes to construction of the statutory provision under which the deduction is sought, the

---

[5] From what regulation would the taxpayer even have drawn warning of the Commissioner's present claim that interest on indebtedness is not deductible because, for example, the creditors also hold stock, or are few in number, or are related by blood or marriage, or have stipulated for a sliding scale of interest, or have agreed in certain events to postpone their claims, or have been or done any or all of the many things that creditors may lawfully be or do?

[6] Accord, *Equitable Life etc. Society* v. *Commissioner*, 321 U.S. 560, 88 L. Ed. 927 (1944); *Old Colony R. Co.* v. *Commissioner*, 284 U.S. 552, 560, 76 L. Ed. 484, 489 (1932); *Noteman* v. *Welch*, 108 F. 2d 206, 213 (C.C.A. 1st 1939). Thus "indebtedness" or "interest" cannot be stretched to cover the

> general rule that 'popular or received import of words furnishes the general rule for the interpretation of public laws,' . . . is applicable."

Thereupon, as an illustration of this principle, the Court offered the following definition of interest.

> "In the business world, 'interest on indebtedness' means compensation for the use or forbearance of money. In absence of clear evidence to the contrary, we assume that Congress has used these words in that sense." Id. 498; L. Ed. p. 424.

These carefully selected words "compensation for the use or forbearance of money" definitely exclude from consideration the question whether the debt was incurred as the purchase price of the debtor's own stock. Obviously there is "forbearance of money" so long as the creditor, voluntarily or in accordance with his written contract, forbears to receive from the debtor the sum owed. And a sum may become owing for any valuable consideration. Manifestly the surrender of the Petitioner's stock in the present case was such a valuable consideration.[7]

Indebtedness and interest are essentially legal concepts, about the broad outlines of which there are no substantial disagreements. Legal and general lexicographers accord

---

obligation incurred by borrowing on shares of stock against short sale (the *DuPont* case) or to include "excess interest dividends" on insurance policies paid wholly at the company's discretion (the *Equitable Life* case) or be narrowed to an accountant's concept of "effective rate" of interest (the *Old Colony R.* case) or so as to exclude a portion of a stipulated rate as being "for expenses" (the *Noteman* case). But neither, we submit, may these terms be narrowed by construction in a way which amounts to the creating of exceptions.

[7] See dissenting opinion of Magruder, J. (R. 102)

them much the same meanings,[8] although the general definitions may in some respects be too broad in including types of "obligations" which the law would not call debts.[9]

Persons think of a "loan" as a first class illustration of a situation in which interest is paid, but "the man in the street" also realizes that many debts arise without money changing hands, as for example, a purchase money mortgage on a house or a note given for a grocer's bill. No one would question that one may go in debt for the price of a horse or for the price of corporate shares, or that, if the corporation itself buys the shares, it is just as much bound to pay the stipulated price and its long term promise to do so is a debt. The Tax Court erred in making "loan" the crucial word. T.C. Opinion (R. 80, 81).

"Debt" and "interest" have never turned upon whether several creditors were kindred to each other or were also stockholders in the promisor corporation or had entered into lawful agreements about the manner in which they would enforce or refrain from enforcing their debts or had stipulated to take less than a maximum rate of interest in certain circumstances.[10] A suggestion that such considerations should be engrafted, by way of qualification or exception upon the definitions quoted above, would not accord with common understanding (and yet is the essence of the Tax Court's decision).

"Debt" and "interest" have nothing to do with a shady distinction between "investments" and "loans." In common speech the term "investment" covers both the common stock and the mortgage bond. Yet the government argued for, and the Tax Court seems to have drawn, some such distinction.

---

[8] See illustrative definitions in Appendix D, p. 57, infra.

[9] Cf. *Deputy* v. *DuPont*, supra, p. 497.

[10] See discussion of the "sliding scale" of interest at pages 19–22, infra.

See T. C. Opinion (R. 81). In the broad and true sense, a purchase money note represents a loan. In a narrow sense it may not. All such issues were avoided by Congress' selection of the generic term "indebtedness."

The Circuit Courts of Appeal have correctly held that

> "The essential feature of the debtor-creditor relation is the presence of a fixed maturity date at which time the holder can demand payment, whether or not there are net earnings."
>
> *Commissioner* v. *H. P. Hood & Sons Inc.*, 141 F. 2d 497 (C.C.A. 1st, 1944)
>
> *Haffenreffer Brewing Co.* v. *Commissioner*, 116 F. 2d 465, 468 (C.C.A. 1st, 1940)
>
> *Commissioner* v. *O.P.P. Holding Corp.*, 76 F. 2d 11, (C.C.A. 2nd, 1935)
>
> *Commissioner* v. *National Grange Mutual Liability Co.* 80 F. 2d 316 (C.C.A. 1st, 1935)

Manifestly, this "fixed maturity date" means a date for the payment of *principal*, for the principal obligation is the one basic element of an indebtedness. Interest is only an incident, which may not even exist, but its existence is absolutely dependent upon there being a debt.

So the first question, and it is an easy one, is: Was Talbot Mills in debt to its noteholders? To give the answer it should be sufficient to point out that the notes are outstanding in a fixed aggregate sum (R. 12, 19, 74, 94); that in each individual note, a definite number of dollars was obviously to be filled in (R. 18, 19, 74, 94); that Petitioner promised unqualifiedly to pay this sum on December 1, 1964 (R. 19); that this maturity might be accelerated in certain circumstances (having nothing to do with "earnings") (R. 21, 22) but might not be postponed (R. 22 — "no such change shall . . . . extend the date for the maturity of the principal of the notes.")

The fixed maturity was buttressed by provisions forbidding any subordination agreement, or mortgage of corporate property, to run beyond December 1, 1964 (R. 21). There was no general subordination, but only a power to make and terminate subordinations, and at the date of trial the notes stood free of subordination (R. 21–22, 14, 78, 32). It may be of some significance that the name of the instrument is "registered note" and that the references throughout are to "this note" or "these notes," and to "interest." (R. 19, 21, 22, etc.)

Manifestly the liability to pay principal ran against all the corporate funds, and was utterly independent of earnings. The notes were fully transferable, the requirement or registration being merely to protect the corporation in dealing from time to time with whoever may be the recorded owner. They were to be outstanding for 25 years and at the end of that time would represent for the corporation a fundamental problem of payment or refunding. They cannot be two different kinds of securities at once,—stock in the hands of a Talbot descendant; debts in the hands of a stranger.

We therefore confidently submit these notes to the test: what would a purchaser of one of these securities justly and properly conceive that he had acquired, the position of a creditor or the position of a proprietor? There is no better test to be used when considering the application of statutory words which are to be given their "usual, ordinary and everyday meaning."

We submit that such a purchaser would consider himself a creditor and would be justly amazed and aggrieved if told that he was not. For a single example, let us assume a bankruptcy. Can it be doubted that he would have a provable claim, even if the notes were still subordinated (which they now are not).

At the other extreme, what proprietary right could he conceivably exercise? Could he bring a stockholder's bill to

attack mismanagement, or would he be entitled to complain only of such matters as are "in fraud of creditors"?

When interest is due, he is entitled to be paid (subject to any subordination) unless payment has been deferred "in good faith" by reason of need. Can there be any doubt but that he could, in the courts, challenge bad faith? And would he, in so doing, be acting in any other right than as creditor?

At maturity, at his own mere demand, he may have the principal (and any accrued and deferred interest) if the corporation has any property with which to meet its debt. He has made no indefinite commitment of his funds to the enterprise. He has acquired the right to an annual reward for their use, varying somewhat with the debtor's degree of success. This reward is interest, or the law knows no true name for it.

It is difficult to argue the obvious, but we have tried to spell it out. It is clear that in common parlance as well as general law the Petitioner's notes, with their central unqualified obligation to pay a fixed sum at a fixed maturity, were the written evidences of an indebtedness. And, if they were, it necessarily follows that the amount paid to service the debt was interest, however fragile, qualified or complicated the interest terms might be. Interest is no necessary feature of an indebtedness. There are debts which do not bear interest. And, if that is so, then, given a debt, it follows that any not unlawful stipulation with respect to the compensation to be paid for forbearance of the debt is interest. It is impossible to arrive at the result reached by the Tax Court and the Circuit Court of Appeals without coming in conflict with *Deputy* v. *Dupont*, *supra*.

And we would call attention to the balance of the quotation from that decision.[11]

"In sum, we cannot sacrifice the 'plain, obvious and

[11] Following the words quoted at p. 14, supra

rational meaning' of the statute even for the 'exigency of a hard case'."

There is no right, either, to sacrifice the plain, obvious and rational meaning, and create exceptions where none are to be found, merely because the Commissioner, or even the Court, thinks that Congress would be well advised to legislate an exception or qualify the absolute words it has chosen to use.

3. INTEREST IS STILL INTEREST, NOTWITHSTANDING IT BE A SLIDING SCALE, OR BE OTHERWISE QUALIFIED, SO LONG AS IT IS THE COMPENSATION FOR THE FORBEARANCE OF A DEBT.

In *Meehan* v. *Valentine*, 145 U.S. 611, 36 L. Ed. 835, this Court said, as follows:

> "In whatever form the rule is expressed, it is universally held that an agent or servant, whose compensation is measured by certain proportion of the profits of the partnership business, is not thereby made a partner, in any sense. So an agreement that the lessor of a hotel shall receive a certain portion of the profits thereof by way of rent does not make him a partner with the lessee. . . . And it is now equally well settled that the receiving of part of the profits of a commercial partnership, in lieu of or in addition to interest, by way of compensation for a loan of money, has of itself no greater effect." 145 U.S. p. 624; 36 L. Ed. p. 841.

It seems perfectly clear that it is a legitimate, and may be a wise, arrangement for a creditor to make with a debtor that the rate of pay which he is to receive for his forbearance of money be related to the success of the debtor during the term of forbearance. And if such an arrangement with a partnership, which is not a legal entity, does not make a creditor a partner, *a fortiori* such an arrangement with a corporation, which is a legal entity, can hardly of its own

force render the creditor a stockholder.[12] Even the Tax Court itself, at the government's own instance, has held that interest may properly be measured in relationship to the debtor's earnings. See *Kena, Inc.*, 44 B.T.A. 217[13]

In other fields, it is perhaps commonly known that royalties on patents and the like are frequently measured with reference to earnings; that during the "depression" the rentals of real estate were sometimes contracted for with reference to the tenant's gross or net receipts; and that compensation contracts may refer to earnings.[14] See, as an instance of the latter sort, *Austin v. United States*, 28 F. 2d 677 (C.C.A. 5th, 1928).

In the case of Petitioner's notes, part of the interest is in no respect referable to earnings. The minimum rate of 2% is absolutely payable without recourse to any computation. But even in the use of the formula, it is always a rate % (to the even ¼%) that is to be ascertained. Never do the noteholders receive a portion of the earnings as such.

Thus, the minimum and maximum extend equally in the two directions from a mesne rate of interest of 6%, and 6% is the rate provided for in all instances in which the computation based on earnings is inapplicable, namely, for the period running to maturity from the end of the previous fiscal year (R. 20) for the period running to the date of accelerated maturity from the end of the previous fiscal year

---

[12] See dissenting opinion of Magruder, J. (R. 101–2, 104)

[13] If the Tax Court possesses some peculiar power of divination in tax cases (under an erroneous extension of the *Dobson* case), which time did it divine correctly, in the *Kena* case or in the present case which does not purport to overrule the *Kena* case!

[14] In compensation cases the statute imposes a requirement of "reasonableness," I.R.C. Sec. 23 (a) (1) (A) but the deduction for interest is unqualified.

(R. 21), and for the period running to a date of voluntary retirement from the end of the previous fiscal year (R. 22). But, as said above, it is always a rate % that is to be ascertained!

We have pointed out that a debt is not dependent upon the existence of an interest obligation, hence it is not wholly appropriate to test the existence of a debt by scrutiny of the interest provisions. Nevertheless it may be in order to mention certain other features of the notes, relating to interest.

There is a power in the corporation, acting "in good faith . . . by reason of the condition of the corporation," to defer the time of payments of interest, but this may not extend beyond the date of maturity. (R. 20) This is clearly a legitimate agreement, and has been held not to alter the quality of an obligation.

Commissioner v. *H. P. Hood & Sons, Inc.* 141 F. 2d 467 (C.C.A. 1st 1944)

Commissioner v. *O. P. P. Holding Corp.*, 76 F. 2d 11 (C.C.A. 2nd, 1935)

The "interest," like the principal may be subordinated, but this may not run beyond the date of maturity. (R. 21) Subject only to such subordination, the right to the interest runs against all the corporate funds, and no dividends may be paid unless the interest is paid in full. (R. 20) Agreements of subordination are in common commercial usage. Even an absolute general subordination to claims of all other creditors, has been held not to turn a debt into stock.

Commissioner v. *O. P. P. Holding Corp., supra*

It follows from all the above, that it was not proper for the Courts below to rest their decisions upon the feature of the variable rate of interest. Nor would it be according due regard to the decisions of this Court to say that this feature, in combination with other features, every one of which are

common permissible arrangements in connection with an indebtedness, turns a creditor into a stockholder when each feature by itself has no lawful tendency to do so.

4. THE COURTS BELOW HAD NO RIGHT TO REGARD "EVIDENCE ALIUNDE THE CONTRACT" OR APPLY FACTUAL TESTS APPLICABLE ONLY IN CASES OF "SHAM" AND THE LIKE.

In *Hamilton* v. *Liverpool, etc. Ins. Co.*, 136 U.S. 242, 34 L. Ed. 419 (1890), this Court said that construction of the correspondence in writing between the parties presented a pure question of law to be decided by the Court.[15] In the present case, there is a complete and integrated document of the sort with respect to which loose ends are never intentionally left and which, by virtue of intended transferability, is the least subject to be controlled by extrinsic evidence.

The Court below, in the course of reaching a particular tax result, has talked about "consideration of the relevant facts," (R. 97), about looking to "actualities of the situation," (R. 98), about looking to see whether interest may be regarded as the "further distribution of profits" (R. 97), and about "exalting form above substance." (R. 98) The Tax Court talked about "intent," (R. 80–81), and obviously meant "motive." All these expressions have merely served to conceal the actual issues.

---

[15] Accord: *Commissioner* v. *Coastwise Transportation Corp.*, 71 F. 2d 104, 105 (C.C.A. 1st, 1934); *Brown* v. *J. C. Shaffer Grain Co.*, 15 F. 2d 514 (C.C.A. 1st 1926); *S. S. Kresge Co.* v. *Sears*, 87 F. 2d 135, 138, 140 (C.C.A. 1st, 1936); *Union State Bank & Tr. Co.* v. *Northwestern Life Ins. Co.*, 55 F. 2d 1070, 1072 (C.C.A. 5th, 1932); *S. H. Kress Co.* v. *Fisher*, 65 F. 2d 682, 683 (C.C.A. 4th, 1933); *Merinos Viesca Y Compania* v. *Pan American P & T Co.*, 83 F. 2d 240, 242 (C.C.A. 2nd, 1936); *National Surety Corp.* v. *Ellison*, 88 F. 2d 399, 403 (C.C.A. 8th, 1937)

In a given case, two main questions could arise:

(a) Is the instrument genuine, and not a sham; is it the agreement itself or merely a technique to support a different arrangement; is it durable or is it only evanescent?

(b) If the instrument is genuine, represents the agreement itself and has a durable existence, then what do its terms mean?

Actually only the second question arises in this case. Yet the Courts below have decided it as if the first were involved.

That the distinction may be clear, we offer several examples of how the first question might have arisen.

(a) The case of "sham": Had the Commissioner contended that the notes were only an appearance, actually vitiated by a secret agreement not to regard them, the scope of permissible evidence would have been wide. Actually the Commissioner made no such contention, the Tax Court made no such finding and the evidence would be incapable of supporting such a finding, if made.

(b) The case of a technique to support a different arrangement: Illustrations are (1) *Wiggin Terminals, Inc.* v. *United States*, 36 F. 2d 893 (C.C.A. 1st, 1929), where the security issued was unquestionably preferred stock, but it was issued to certain persons to hold only until through the medium of dividends they had received a 100% bonus upon a certain loan and then was to come back to the Company. The money paid as dividends was held deductible as interest, because the stock and the dividends were nothing but an agreed vehicle for paying what had actually been stipulated for as interest. (2) *Arthur R. Jones Syndicate* v. *Commissioner*, 23 F. 2d 833 (C.C.A. 7th, 1927) where stock was used as a device to conceal a usurious loan. In the present case there is no evidence, or purported finding, of the existence of a like situation.

(c) The case of a temporary expedient: The typical example is *Gregory* v. *Helvering*, 293 U.S. 465 (1935). There, direct action would have resulted in a taxable gain. Therefore unnecessary indirect action was taken, and a structure raised like a scaffolding, to be torn down the instant the tax result was obtained.[15a] The present case presents nothing of the sort.

There is a fundamental distinction between (a) a transaction having no reality of its own, but erected as a form to meet superficially some language in the tax statute, and then be dissolved (the *Gregory* case), and (b) a transaction which, though motivated in whole or in part by reasons of tax advantage, is a genuine, durable rearrangement of the business or financial relations of the parties (the present case). The latter transaction cannot rightfully be ignored.[16]

The second question, therefore, is the only one in this case: — what do the terms of the notes mean?

These instruments are not fairly to be described as "ambiguous." What they mean and what they are is essentially a question to be determined from the documents themselves, an issue customarily treated as one of "law" rather than of "fact."

These notes mean the same thing when they are issued by the Talbot Mills as they would if issued by the United States Steel Corporation or by a railroad in reorganization. They mean the same thing when held by a person who is also a stockholder as when held — as they all might come to be

---

[15a] See *Helvering* v. *Alabama A. Limestone Co.*, 315 U.S. 179 (1942) pp. 184–5, "Transitory phases."

[16] Matters relating to corporate financing concern the very existence of a corporation. Cf. *Lydia E. Pinkham Medicine Co.* v. *Gove*, 303 Mass. 1, 12. (1939). And see discussion of *Gregory* v. *Helvering*, in *National Investor's Corporation* v. *Hoey*, 144 F. 2d 466, 468 (C.C.A. 2d, 1944).

— by a person who holds no stock at all. To say otherwise is to make a travesty of the law for the sake of the revenue.

The Courts below have wholly misused the language quoted by them from *Commissioner* v. *Proctor Shop, Inc.*, 82 F. 2d 792, 794, 30 B.T.A. 721, 725, with respect to use of "evidence aliunde the contract." That language was proper with respect to *Arthur R. Jones Syndicate* v. *Commissioner*, 23 F. 2d 833, 834, and to the *Wiggin Terminals* type of case, as to which see p. 23 this brief *supra*, from which decision quotation was made in the *Proctor Shop* decision. But it was not proper in the present case.

One fundamental error of the Tax Court's opinion lies in its confusion of "intent" with "motive." Obviously, the petitioner's clear intent was to issue this specific security, just as it is, a security which has every essential feature of an indebtedness, and every feature of which has in one case or another been held to be a permissible feature of an indebtedness.

Whence then comes the "doubt" as to "the real nature of the instant transaction"? It comes from an illegitimate concern with matters of motive, and an invalid conception of the use which may be made of extrinsic considerations dealing with motive. This "doubt" does not render the notes ambiguous, nor does it authorize the consideration of "evidence aliunde the contract" (not really to "explain" but actually, as used by the Court) to contradict their terms.

It was therefore completely erroneous for the Tax Court and the Circuit Court of Appeals to hold themselves entitled to give weight to such facts as that the Petitioner was owned by a few stockholders (R. 74, 80, 94, 98), or that the stockholders were relatives (R. 74, 80, 94, 98), or that the noteholders acquired their notes through giving up stock (R. 79, 80, 98), or that the holders of the notes also continued to hold their remaining stock (R. 80, 98), or that a small amount rather than a large amount ever changed hands.

(R. 80, 96, 99), and upon the basis of such considerations arrive at the conclusion that for purposes of taxation the notes were not the evidences of indebtedness which for every other purpose in general law and ordinary business life they were.

If this principle is not firmly maintained the tax status of various types of instruments, howsoever unambiguous, will become legally unpredictable despite the clear language of the statute. Various earlier decisions of the Circuit and District Courts, and of the Tax Court or Board, are not thoroughly reconcilable; but hitherto, at least, no authority whatever could have been adduced for treating as stock a security which was directly and truly a promise to pay a fixed sum at maturity and meanwhile to pay sums computed annually, either fixed or ascertainable, as the compensation

---

A group of cases in which securities called "stock" were held to represent indebtedness:

Commissioner v. *Proctor Shop*, 82 F. 2d 792 (C.C.A. 9th, 1936); *Helvering* v. *Richmond F. & P. R. Co.*, 90 F. 2d 971 (C.C.A. 4th, 1937); *Palmer, Stacy-Merrill, Inc.*, 39 BTA 636; Affmd. 111 F. 2d 809 (C.C.A. 9th, 1940); *Diamond Calk Horse Shoe Co.* v. *United States*, D.C.D. Minn. 7/20/40, CCH Par. 9641, Appeal Dismissed on Stipulation 116 F. 2d 284 (C.C.A. 8th, 1940)

may be compared with cases reaching the contrary result:

Haffenreffer Brewing Co. v. *Commissioner*, 146 F. 2d 465, 468 (C.C.A. 1st, 1940); *Brown-Rogers-Dixson Co.* v. *Commissioner*, 122 F. 2d 347 (C.C.A. 4th, 1941); *Pacific Southwest Realty Co.* v. *Commissioner*, 45 BTA 426, CCH Dec. 12, 127, affd. 128 F. 2d 845 (C.C.A. 9th, 1942); *Parisian Inc.* 46 BTA 1279, CCH Dec. 12, 439-B, affd. 131 F. 2d 394 (C.C.A. 5th, 1942); *Commr.* v. *Schmoll Fils Assoc.*, 110 F. 2d 611 (C.C.A. 2nd, 1940) ("debenture").

for postponing the principal payment. Now such a result is reached, with respect to a concededly genuine security, by treating it as if it were ambiguous and then contradicting its plain meaning. Extrinsic evidence may not lawfully be used to such an end.

5. THE PETITIONER HAD A RIGHT TO REARRANGE ITS AFFAIRS WITH FRANK REGARD TO MINIMIZING THE INCIDENCE OF TAXATION.

In *Bullen* v. *Wisconsin*, 240 U.S. 625, 60 L. Ed. 830 (1916), this Court said,

> "We do not speak of evasion, because, when the law draws a line, a case is on one side of it or the other, and if on the safe side is none the worse legally that a party has availed himself to the full of what the law permits. When an act is condemned as an evasion, what is meant is that it is on the wrong side of the line indicated by the policy if not by the mere letter of the law." 240 U.S. p. 630–631, 60 L. Ed. p. 835.

The concern of the Tax Court and of the Circuit Court of Appeals with the Petitioner's so-called "tax motives" was improper under the language quoted above and, in effect if not in form, was a flat denial of the Petitioner's right to deduct the interest on notes outstanding if such notes were issued with tax objectives in mind.

Counsel have relied upon the famous words of Mr. Justice Holmes for many years. Constantly they have advised clients that they might so rearrange their affairs as to present the least exposure to taxation under the laws, provided only that in so doing their arrangements were genuine and durable and not false fronts for other underlying arrangements at variance nor temporary devices like the scaffolding that surrounds a building (Cf. *Gregory* v. *Helvering*, 293 U.S. 465). The citizens of this Country are entitled to know from this

Court whether that principle still prevails in its former integrity.

It is manifest that if the circumstance of "tax motives" may be utilized by the courts in the manner in which it was utilized in the opinions below, the words of *Bullen v. Wisconsin* become simply a trap for the unwary.

We recognize what is said about the "policy, if not . . . the mere letter of the law." But the policy of a federal tax statute is to be found in the statute itself, possibly illuminated by its history, and not in the policy-making tendencies of judges. It is notable that in the decisions below there was not made even the faintest attempt to interpret the words of I.R.C. Section 23(b) in the light of context or of other portions of the statute or of previous enactments or of legislative history. Instead the words were ignored and the policy was summoned into existence out of the judicial imagination.

It seems impossible, reading the majority decision in the Circuit Court of Appeals and the Tax Court decision, to avoid the conclusion that these tribunals in effect legislated against the Petitioner because of the belief that the Petitioner had substituted notes for stock to obtain a tax benefit to it.[18] Yet the Petitioner was thoroughly entitled to seek this result, in reliance upon what was said by this Court in *Bullen v. Wisconsin* and it is common knowledge that everyone does it whenever feasible.

The Petitioner went about the matter openly, issued notes that were absolutely genuine and vitiated by no secret underlying arrangement, incurred the heavy responsibility of facing a problem of refinancing at maturity and incurred a fixed obligation to pay at least 2 per cent interest in any event and an equally absolute obligation to pay as much

---

[18] See, for a like technique, *Commissioner v. John Kelley Company*, 146 F. 2d 466, 468, (C.C.A. 7th, 1944) towards the end of the page.

more as might be determined by application of the interest formula. No issue of sham, temporary device or the like was or could have been presented.

It is natural and unavoidable that under pressures of taxation, people will seek to arrange their affairs to keep its incidence upon them at a minimum. Indeed, the complexity of tax laws, and the variety of circumstances under which they now impinge upon every move a man can make with respect to property have actually resulted in altering the standards of good judgment necessary to be applied to business arrangements or dispositions to be made with respect to property.

No one concerned with corporate finance or with the settlement of the affairs of an individual can today regard desired economic objectives in a tax vacuum. It is necessary to consider all objectives in the light of what may be done without incurring tax consequences so heavy as to prohibit the pursuit of those objectives. If, upon top of this, one is denied the right to rely upon the plain, clear language of the statute, and may expect what one does to be distorted by findings based on motives, the handicap becomes indeed grievous.

It is utterly unrealistic and unreasoning to assume that people will embark upon transactions wearing blinders, like a horse, to keep them from seeing the tax problems which lie on both sides of the road. The fundamental purpose of every business enterprise is to make money *and to keep it after it is made*, not just to make it in the spirit of a game, with indifference to its ultimate disposition. The choice between operating as a partnership or as a corporation necessarily involves a factor of "tax motives." So do innumerable other decisions. This case cannot be decided against the Petitioner without imperiling decisions made in every such field.

If we approach the present case with the utmost candor it all comes back to this: That the petitioner has deliberately, and for full consideration, incurred an indebtedness with

terms which (a) impose a *current* burden reasonably adaptable to varying ability to pay dependent upon results of the business, and (b) do not unreasonably impair its *current* credit position with banks and others. The Commissioner complains, and has persuaded the Tax Court, that it should not be able to do this since a "tax motive" existed.[19] But this is not the law and it has nothing to do with the question of what is interest. The taxpayer is entitled to a lawful judgment, regardless of its "motives."

Bullen v. *Wisconsin, supra*

6. THE DECISIONS BELOW ARE PURE "JUDICIAL LEGISLATION," NEITHER PERMISSIBLE NOR EVEN WISE.

Courts have had frequent occasion to admonish themselves against indulging in judicial legislation, even in the face of strong temptation. Such admonitions are frequently lively and pungent — bearing an implied tribute to the strength of the temptation. Thus

> "We should of course be faithful to the meaning of a statute. *But after all Congress expresses its meaning by words.* If legislative policy is couched in vague language, easily susceptible of one meaning as well as another in the common speech of men, we should not stifle a policy by a pedantic or grudging process of construction. To let general words draw nourishment from their purpose is one thing. *To draw on some unexpressed spirit outside the bounds of the normal meaning of words is quite an-*

---

[19] The curious thing about the Tax Court's position is that even the conclusion it draws from its erroneous use of the "tax motive" is wrong. The existence of the "motive" can actually only testify to the genuineness of the intent to create an indebtedness, *for only if an indebtedness were actually created could the tax motive, upon which the Tax Court places so much weight, succeed and the deduction be achieved.*

other. For we are here not dealing with the broad terms of the Constitution 'as a continuing instrument of government' but with part of a legislative code 'subject to continuous revision with the changing course of events.' *United States* v. *Classic*, 313 U.S. 299, 316, 85 L. Ed. 1368, 1378, 61 S Ct 1031." (Italics supplied)

Addison v. *Holly Hill Fruit Products*, 322 U.S. 607, 617, 88 L. Ed. 1488, 1496

"It is not enough merely that hard and objectionable or absurd consequences, which probably were not within the contemplation of the framers, are produced by an act of legislation. Laws enacted with good intention, when put to the test, frequently, and to the surprise of the law maker himself, turn out to be mischievous, absurd or otherwise objectionable. But in such case the remedy lies with the law making authority, and not with the courts."

Crooks v. *Harrelson*, 282 U.S. 55, 60 (1930), 75 L. Ed. 156, 175

"What the government asks is not a construction of a statute, but, in effect, an enlargement of it by the Court, so that what was omitted, presumably by inadvertence, may be included within its scope. To supply omissions transcends the judicial function."

Iselin v. *United States*, 270 U.S. 245, 251 (1926) 70 L. Ed. 566, 69–70

See also,

Noteman v. *Welch*, 108 F. 2d 206, 208, 215 (C.C.A. 1st, 1939)

Mead Corporation v. *Commissioner*, 116 F. 2d 187, 191 (C.C.A. 3d, 1940)

Forstman v. *Rogers*, 128 F. 2d 126, 129 (C.C.A. 3d, 1942)

Western & Southern Life Ins. Co. v. Hunce, 116 F. 2d 1008, 1010 (C.C.A. 6th, 1941)

Decisions tainted with the vice of judicial legislation frequently have certain surface characteristics by which they tend to be recognized. In the present case, for example, legislation rather than decision is implicit in the course of the Tax Court in applying an undefined standard of "proper" interest and omitting all reference whatever to the statute itself. Again, when the petitioner's notes are gratuitously branded by the Tax Court as "voluminous and complex," when it is obvious that they are brevity and simplicity itself compared with the average major corporate security and underlying indenture, it is evident that the Court is building up a fighting approach to a predetermined conclusion.

By the use of its masterly ambiguity — "proper interest," the Tax Court in effect concedes that the sums in question were interest from some point of view, for otherwise the word "proper" would be meaningless. This word "proper" is the key word of the Tax Court's opinion, for in this one word the Tax Court has covered an unexpounded construction of a statute which it fails to quote.

Actually the statute is straightforward and all-inclusive. To say that under it some interest is "proper" interest and other interest is not "proper" interest, is either to say that the words "interest" and "indebtedness" as used in the statute were not used in their common and ordinary meaning or else to say that exceptions to the express grant of a deduction for "all" interest may be picked out of the thin air. On either alternative, what is involved is judicial legislation and nothing else, for neither position can find any support in the express words of the statute or even in implications legitimately drawn from the structure of the statute or the interplay of its provisions.

A construction of a statute which finds support neither in

the text of the particular provision nor in the structure of the statute as a whole is particularly suspect when it precipitates complicated and repetitive investigations of facts. "Had Congress intended to impose this heavy administrative burden of making such sweeping investigations into the factual backgrounds . . . it would have done so in clear and explicit language."[20] The present case affords an excellent example.

Obviously the Tax Court did not confine its inquiry to a comparison of the statute on the one hand and the terms of the notes on the other. It took into account motive, personal relationships, balance between noteholdings and stockholdings and the like. And it concluded that "what the parties really intended to create was a security retaining the profit-sharing advantage of stock, leaving intact their voice in the management, but extending a tax advantage to the corporation not possible in stock," hence creating no "proper" indebtedness.

Now whether "their voice in the management" was left intact was something that neither flowed, nor was in any wise capable of flowing, from the notes. It depended, on the contrary, on how much stock each noteholder held and whether he continued to retain it. Should either notes or stock be alienated or should even their proportions be varied, this characteristic which the Tax Court attributes to the notes, and which is really no characteristic of the notes at all, would disappear. Had the notes in their inception been issued to entirely different persons, the alleged characteristic could not have been claimed to exist at all. Similar comments could be made with respect to the fact of the personal relationships, the fact of "tax motive" and the like. They are transient and changeable conditions. Only the terms of the notes themselves are the fixed and certain element.

---

[20] *Plimpton v. Commissioner of Internal Revenue*, 135 F. 2d 482, 486 (C.C.A. 1st, 1943), an admirable statement of the principle, in a First Circuit case not very dissimilar.

Thus a dilemma is presented. Either notes like these, no matter to whom or by whom issued or held, have always the same status in reference to the interest deduction, in which case the Tax Court has reached its conclusion by improperly concerning itself with irrelevant matters. Or else notes identical with these may or may not in each instance bear deductible interest; dependent upon a collateral inquiry which may range as wide as the great variety of facts which may bear upon the situation of the issuing corporation, the situation of the recipients of the security, the interplay and balance of motives and the like. And the investigation of such matters would be recurrent because the several factors involved are capable of changing from time to time. Had Congress intended to direct such investigations, for the purpose of resolving such distinctions, it would have used some language quite different from "all interest upon indebtedness."

Furthermore, if a rule is enunciated that only some sorts of interest are deductible, or that "interest" and "indebtedness" as used in the statute are to be given something other than their common and ordinary meaning, matters of substantially greater importance to the total economy than the problems of the Talbot Mills become clouded with doubt.

For example, it is common knowledge that in current railroad reorganizations, conducted under public supervision, large amounts of bonds are issued bearing interest so directly related to earnings as to be impossible to distinguish, in principle, from the interest provisions of the present notes. As an illustration, we have appended as Appendix B a condensed description of the terms relating to interest upon the recently-issued Erie Railroad Company General Mortgage Income 4½% Bonds, due January 1, 2015. These provisions, while not directly expressed in a sliding scale, actually have the same effect as a sliding scale, with a maximum rate, with an overall limit of 13½% on the cumulation of unearned

interest, with a provision for paying interest only in multiples of ¼% and with earnings adjusted for deficits of prior years in computing the currently payable rate. . . .

Every feature of the Talbot Mills Notes (laying aside for the moment the sliding scale of interest) is obviously a permissible feature of an indebtedness. To hold that the additional feature of a sliding scale of interest is the essential factor which turns what is otherwise clearly a note into "stock" for tax purposes, could hardly fail to cast doubt upon the deductibility of interest upon issues such as the bonds above described. And yet it is safe to assume that if the interest upon the Erie Income Bonds is not deductible, the consequence upon the revenues available for the Erie stock would obliterate assumptions legitimately made in formulating the terms of the reorganization itself.

And if, on the other hand, the Erie interest is deductible and the Talbot Mills interest is not, then there is an intolerable discrimination between the two corporations, in effect permitting to one and denying to the other the right to have a certain kind of security and have it recognized for tax purposes.

Is there one law for corporations with 15 stockholders and another law for corporations with 15,000 stockholders? Is there one law for corporations whose security holders are related and another law for corporations whose security holders are unrelated? Is there one law for the Erie Railroad and another law for the Talbot Mills?

Finally, we come to the uncertainties in the application of other provisions of the Internal Revenue Code created by the Tax Court's failure to apply to the petitioner's notes a proper interpretation of Section 23 (b) relating to the deductibility of interest. A complete development of this inquiry would require the quotation and analysis of separate statutory provisions more numerous than the compass of this brief would readily admit. However, the essential nature of the problem

is doubtless capable of being indicated with reasonable brevity.

In the structure of the Code certain terms bear certain relationships to each other, whether of affiliation or of contrast. Thus the term "interest" is tied up with "evidences of indebtedness" and "indebtedness," which latter term is doubtless equivalent to the term "debt" as variously used in the statute. In contrast with "evidences of indebtedness" appears frequently the expression "shares of stock," with which latter term the expressions "stockholder," "class of stock" and "dividend" are associated. Therefore, any denial that the petitioner's notes are evidences of indebtedness or that the annual sums accrued thereon are interest precipitates a further issue whether these instruments are shares of stock and the annual sums accrued thereon dividends.

Now the expressions "shares of stock," "stockholders" and "dividends" are properly to be given their "usual, ordinary and everyday meaning,"[21] this principle of statutory construction being by no means limited to its application to any one particular section of the Code. And it is impossible truthfully to call these instruments "shares of stock" within the usual import of that expression.

To illustrate the difficulties to be encountered and the number of different occasions upon which, or issues with respect to which, a false and artificial character would have to be attributed to these instruments in order to apply to them, in a manner consistent with the Tax Court's opinion, the various provisions of the Code, the following may be mentioned:

Consider, for example, whether, if they become worthless, they would be subject to the provisions of Section 23 (g) dealing with "capital losses" or Section 23 (k) dealing with

---

[21] Quoted from *Deputy* v. *DuPont*, 308 U.S. 488, 498.

"bad debts." If they are not "evidences of indebtedness" within the meaning of Section 23 (k) (3); are they then "shares of stock in a corporation" within the meaning of Section 23 (g) (3)? And, if they are not the latter, under what section of the Code is the loss deductible and with what qualifications or limitations?

Under Section 23 (z), dealing with taxes and interest paid to co-operative apartment corporations, would a corporation which had only common stock outstanding, and which had financed in lieu of a mortgage by issuing notes like ours, be a corporation having "one and only one class of stock outstanding" within the meaning of Section 23 (z) (2) (A) (i); and would the holders of these notes, although actually not interested in occupying apartments in the building owned or leased by such corporations, nevertheless have to be counted for the purposes of Section 23 (z) (2) (A) (ii)?

Is there any reasonable basis for believing that a taxpayer could successfully claim that the annual sums accrued and paid upon these notes are "dividends" for the purpose of the "dividends paid credit" under Section 27, as forming part of the basic surtax credit under subsection (b) (1)? Or, if these notes had been issued prior to December 31, 1937, would not reasonable amounts, used or irrevocably set aside to pay or retire portions of the same, fairly be entitled to some consideration for the purposes of Section 27 (a) (4)?

Under the provision of Section 117 (i), if the losses of a bank from the sales or exchanges of any "evidence of indebtedness issued by any corporation * * * with interest coupons or in registered form" exceed the gains of the taxable year from such sales or exchanges, no such sale or exchange is to be considered a sale or exchange of a capital asset. If a bank came to hold some of the petitioner's notes would the bank be denied the benefit of this section in connection with losses later realized upon the disposition of them?

Under Section 125 (d), the term "bond" includes any

"evidence of indebtedness, issued by any corporation and bearing interest * * * * with interest coupons or in registered form." Would a holder of these notes who might acquire them at a price in excess of par value be denied the privilege of amortization under Section 125? Some difficulty in settling upon a method of amortization might be presented by the sliding scale of interest, but it would equally be presented in the case of the Erie Railroad Bond referred to at p. 34, supra.

Under Sections 332 and 502, would the annual sums paid on these notes be "personal holding company income"? If they are not "interest," they could be includable only if held to be "dividends."

Consider also the problems to arise in connection with "equity invested capital" and the reduction of equity invested capital under Section 718 for the purposes of the excess profits tax. Also, the problem in connection with "borrowed invested capital" under Section 719; and consider how the expression "borrowed invested capital" is utterly incompatible with the Tax Court's notion of a criterion based upon a difference between "loans" and "investments."

A consistent result can be *forced* by saying that these notes are "shares of stock," that they represent "equity invested capital," that the annual sums accrued and paid thereon are "dividends" and the like. But the result cannot be reached by any fair interpretation of the terms just used and can be reached only by saying that, having decided that the notes are not evidences of indebtedness, they have to be stock, because that is all that is left. This would be merely balancing one error against another and pyramiding the consequences of the "judicial legislation" involved.

All these problems are to be avoided by simply attributing to the words "All interest . . . upon indebtedness" their plain and natural meaning, and giving to the Petitioner's notes themselves a proper judicial inspection to see if they embody a debt.

7. If There is Any Doubt About the Meaning of the Statute, it is the Kind of Doubt Which Should be Resolved in the Taxpayer's Favor.

In *Gould* v. *Gould*, 245 U.S. 151, 62 L. Ed. 211 (1917), this Court said,

> "In case of doubt" tax statutes "are construed most strongly against the government, and in favor of the citizen." 245 U.S. p. 153, 62 L. Ed. p. 213

This rule should have sufficient vitality at least to cause the courts to adhere to the plain generality of the text of a statutory deduction and refrain from engrafting upon it unwarranted exceptions. It is thoroughly capable of being reconciled with the rule of "strict construction" of exemptions, credits, deductions and the like, found in such cases as *Woolford Realty Co.* v. *Rose*, 286 U.S. 319, 76 L. Ed. 1128 (1932).

Careful examination of cases of the latter sort[22] will show that they have never expressly overruled the decisions for construction in the taxpayer's favor; that they have never used the "strict construction" rule to deprive a taxpayer of the benefit of the plain, fair, ordinary meaning of a provision establishing a deduction; and that the rule of strict construction has only been used to deny claims for the extension or expansion, by implication, of deduction sections, or to refute arguments which would have precluded the Court from exercising its proper judicial function in the resolving of genuine questions of construction.

We have materially expanded the argument, with citations, in Appendix A to this brief, to which attention is respectfully requested.

It takes little more than lip service to the principle enunciated in *Gould* v. *Gould* to reach the conclusion in the

[22] See cases abstracted in Appendix A, pp. 44–50, infra.

present case that a statute providing for the deduction of *all* interest on indebtedness may not by judicial construction be cut down into a deduction of some types of interest on some indebtedness. Unless and until the principle of *Gould* v. *Gould* is expressly overruled by this Court, the decision below stands in inescapable conflict with it:

8. THE DECISIONS BELOW ARE NOT SUSTAINABLE UPON THE BASIS OF DOBSON V. COMMISSIONER.

In *Dobson* v. *Commissioner*, 320 U.S. 489, 88 L. Ed. 248; rehearing denied, 321 U.S. 231, 88 L. Ed. 691 (1943) this Court said,

> "It is contended that the applicable statutes and regulations properly interpreted forbid the method of calculation followed by the Tax Court. If this were true, the Tax Court's decision would not be 'in accordance with law' and the Court would be empowered to modify or reverse it. Whether it is true is a clear-cut question of law and is for decision by the courts . . ." 320 U.S. p. 492, 88 L. Ed. p. 251.

The case related to whether certain transactions in separate years, relating to the same subject matter, should be treated for tax accounting purposes as a single transaction or as a series of separate transactions. This Court held that that Tax Court's determination of this issue should stand because the issue presented essentially a question of fact. The decision accords new emphasis to the finality to which decisions of questions of fact by the Tax Court are entitled when supported by substantial evidence. But, as the above quotation shows, it does not impart immunity to errors of law committed by the Tax Court.

What constitutes sound accounting practice is an issue of fact. There is little law about accounting. If a man promises to pay money based on certain operating results, to be

ascertained in accordance with sound accounting practice, the issue of how much is due from him would be almost completely a question of fact. But "indebtedness" and "interest" are very strongly legal conceptions. There is a great deal of law about them and it is far more likely that Congress used these words in the deduction section with reference to the common understanding of their meaning — than that it used them in some new and strange sense,[23] peculiarly related to taxation, which only "an administrative body having special competence to deal with the subject matter would have the insight to interpret and apply." [24]

In the present case, practically all material facts are stipulated. There is a clear, complete and unambiguous instrument to be analyzed and a direct and categorical provision of the statute to be construed and applied to it. There is no evidence or suggestion of the notes being a sham, or temporary expedient or instrumentality for accomplishing an entirely distinct purpose. Hence, no substantial issue of fact is presented upon which a finding supported by evidence would be final.[24] The only dispute of fact which the Tax Court opinion even contemplates is the issue made by the Tax Court with respect to "intent," which upon analysis is nothing but an improper concern with a question of "motive."

The meaning of the words in the deduction section; whether the deduction section is absolute or subject to the reading in of implied exceptions; whether the meaning of the section may be varied by applying a distinction between "loans" and "Capital investments"; whether the notes do or do not evidence debts; whether or not the annual sums agreed to be paid thereon to service the debts are payments of the type which the law knows as interest; whether a complete and

---

[23] Cf. *Commissioner* v. *Raphael*, 133 F. 2d 442, 445 (C.C.A. 9th, 1943).

[24] See dissenting opinion of Magruder, J. (R. 105–106)

unambiguous written instrument may be distorted from its true intendment by extrinsic evidence and discussions of "motive"; whether a confusion of "intent" and "motive" is erroneous and prejudicial; whether it may be held that every feature of an instrument is a permissible feature of a debt and yet that all features together make the instrument not a debt, notwithstanding that the central feature is an unqualified promise to pay a fixed sum at a fixed maturity; whether a purported statutory construction, implied in a decision, amounts practically to judicial legislation; whether a particular application of a statute would violate established canons of construction; all these are questions of law and not of fact and on each one of these the Tax Court (and the Circuit Court of Appeals) arrived at an erroneous conclusion or it would not have reached the result it did.

Our position is decisively justified by

Trust u/w Bingham v. *Commissioner of Internal Revenue*, U.S. , 89 L. Ed. 1191 (1945)

in which the power to review the Tax Court on issues of law was reaffirmed with respect to the deduction afforded by I.R.C. § 23 (a) (2).

And there is one further suggestion which we take the liberty of offering, namely that the scope of review of Tax Court decisions ought not to be startlingly unlike the scope of review of United States District Court decisions in tax cases or of Court of Claims decisions in tax cases.

A taxpayer need not pay a deficiency as a preliminary to taking a case to the Tax Court. But the Tax Court is not a court of exclusive jurisdiction. If the taxpayer can raise the money, he may pay the deficiency, claim a refund and sue in the District Court or the Court of Claims.[25]

---

[25] I.R.C. §§ 322, 3772; Jud. C. § 24, amended, U.S.C.A. § 41 (5), (20); Jud. C. § 145, U.S.C.A. § 250 (1).

A good deal has been said about the special competency of the Tax Court (e.g. in the *Dobson* case, and in the *Bingham* case, U.S. p. , 89 L. Ed. p. 1200, by the concurring justices). But "special competency" in combination with a non-exclusive jurisdiction of the subject matter does not too strongly suggest that Congress mean to constrain the Circuit Courts of Appeal and this Court in their reviewing functions.

It will be unfortunate if the taxpayer's ability finally to have a lawful application of the tax statute by reviewing courts comes to turn upon the question whether he can raise the money to pay a deficiency. And if taxpayers turn away from the Tax Court and pursue other remedies, because of unreasonable extensions of the *Dobson* case, it will be strange to come to the logical next claim of the government, namely, that Tax Court decisions, *as precedents*, are superior to decisions of this Court or of the Circuit Courts or Court of Claims.

We therefore respectfully submit that the Tax Court decision in this case, involving fundamentally only issues of law, must not find shelter under the *Dobson* case by stretching the conception of what is "fact" to cover them.

Respectfully submitted,

MELVILLE F. WESTON
Attorney for
TALBOT MILLS,
Petitioner.

POWERS & HALL
Of Counsel.

APPENDIX A.

The rule for resolving doubts in the taxpayer's favor and the rule of "strict construction" of exemptions and the like are not inconsistent upon a proper analysis of the cases supporting the latter "rule."

In a matter of construction, some initial inclination in the taxpayer's favor is to be derived from the rule that tax statutes "in case of doubt . . . are construed most strongly against the government, and in favor of the citizen,"

Gould v. *Gould*, 245 U.S. 151 (1917)

It has been said that this rule has been "modernly more honored in the breach than in the observance,"

Frost Lumber Industries v. *Commissioner*, 128 F. 2d 693, 694 (C.C.A. 5th, 1942)

but the authorities for it are still impressive.[1] It ought, even in cases of deductions, at least to militate against the making

---

[1] *Bowers* v. *New York & A. Lighterage Co.*, 273 U.S. 346, 350 (1927); *Crooks* v. *Harrelson*, 282 U.S. 55, 60, 61 (1930); *Old Colony R. Co.* v. *Commissioner*, 284 U.S. 552, 561–2 (1932); *White* v. *Aronson*, 302 U.S. 16, 20 (1937); *Hassett* v. *Welch*, 303 U.S. 303, 314 (1938); *Corporation of America* v. *McLaughlin*, 100 F. 2d 72, 74 (C.C.A. 9th, 1938); *Commissioner* v. *Rabenold*, 108 F. 2d 639, 640 (C.C.A. 2d, 1940); *Partee* v. *Commissioner*, 114 F. 2d 716, 719 (C.C.A. 6th, 1940); *United States* v. *Motsinger*, 123 F. 2d 585, 589 (C.C.A. 4th, 1941); *Feitler* v. *Harrison*, 126 F. 2d 449, 451 (C.C.A. 7th, 1942); *Coleman* v. *United States*, 37 F. Supp. 273, 277 (Ct. Cl. 1941); *Frost Lumber Industries* v. *Commissioner*, cited in text supra; *Mayer* v. *Reinecke*, 28 F. Supp. 334, 339–40 (D.C.N.D. Ill., 1939); *Penn. Co. for Insurances etc.* v. *United States*, 39 F. Supp. 1019, 1022 (D.C.E.D. Pa. 1941).

of strained constructions in the government's favor,[2] doing violence to the well established meaning of the words which Congress has used.

There is presented, nevertheless, the problem of reconciling the principle mentioned above with the principle relating to "strict construction" of exemptions, credits, deductions and the like. Some courts may have deemed the two principles to be incompatible,[3] but we do not believe that such a conclusion is required by any of the decisions of the Supreme Court, which are as follows:

Woolford Realty Co. v. *Rose*, 286 U.S. 319 (1932).
New Colonial Ice Co. v. *Helvering*, 292 U.S. 435 (1934).
White v. *United States*, 305 U.S. 281 (1938).
Deputy v. *DuPont*, 308 U.S. 488 (1940).
Helvering v. *Northwest Steel Rolling Mills*, 311 U.S. 45 (1940).
Helvering v. *Ohio Leather Co.*, 317 U.S. 102 (1942).
Equitable Life Assurance Society v. *Commissioner*, 321 U.S. 560; 88 L. Ed. 927 (1944).

These cases are briefly abstracted hereinafter (pages 46–49 infra) with quotations, in support of what is now to be said with respect to them.

The "rule," of "strict construction" of exemptions or deductions, has been variously applied[4]; and the boundaries

---

[2] That was the use actually made of the rule in *Old Colony R. Co.* v. *Commissioner*, cited Note 1, page 44, supra.

[3] *Maloney* v. *Portland Associates*, 109 F. 2d 124 (C.C.A. 9th, 1940).

[4] *Uhl Estate Co.* v. *Commissioner*, 116 F. 2d 403 (C.C.A. 9th, 1940); *Antietam Hotel Corporation* v. *Commissioner*, 133 F. 2d 274, 278 (C.C.A. 4th, 1941); *Commissioner* v. *Hopkinson*, 126 F. 2d 406, 411 (C.C.A. 2d, 1942); *Harwick* v. *Commissioner*, 133 F. 2d 732, 735 (C.C.A. 8th, 1943).

are not always clear between it and the general principle relating to the burden of proof which is always incumbent upon a taxpayer seeking to overcome a deficiency. On the other hand it has been said, even in cases of deductions, that "unjust and oppressive consequences" are to be avoided.[5]

At all events, it will be clear, from an examination of the Supreme Court decisions cited above and hereinafter abstracted, that

(1) The decisions, embodying the general rule of construction in the taxpayer's favor, have never been overruled expressly and by name.

(2) The Court has never used the "rule" of "strict construction" to deprive a taxpayer of the benefit of the fair, plain ordinary meaning of a provision establishing a deduction.

(3) The Court has only used the "rule" to deny claims for the extension or expansion, by implications, of deduction sections, or to refute arguments which would have precluded the Court from exercising its proper judicial function in the resolving of genuine questions of construction.

The cases referred to are as follows:

Woolford Realty Co. v. *Rose* 286 U.S. 319 (1932).

Upon a consolidated return, the taxpayer endeavored to deduct the losses which one of the affiliated corporations had incurred prior to the period of consolidation. In denying this claim the court said in part

"A taxpayer who seeks an allowance for losses suffered in an earlier year must be able to point to a

---

[5] *Boston Consolidated Gas Co.* v. *Commissioner,* 128 F. 2d 473, 476 (C.C.A. 1st, 1942); *Helvering* v. *Cannon Valley Milling Co.,* 129 F. 2d 642, 647 (C.C.A. 8th, 1942).

specific provision of the statute permitting the deduction, and must bring himself within its terms." Id. p. 326

New Colonial Ice Co. v. *Helvering*, 292 U.S. 435 (1934). The taxpayer, which had succeeded in reorganization to the business of a predecessor corporation, endeavored to deduct the net losses of such predecessor. The court's language includes

> "Obviously, therefore a taxpayer seeking a deduction must be able to point to an applicable statute and show that he comes within its terms." Id. p. 440

White v. *United States*, 305 U.S. 281 (1938). The issue was whether a particular loss, the existence of which was unquestioned, was deductible in its entirety as an "ordinary" loss or was subject to certain limitations as a "capital" loss. A complicated question of construction was thus afforded, involving a choice between alternative statutory provisions. It would seem that the taxpayer argued that because of "doubt," the construction favoring them should be adopted. The court replied

> "We are not impressed by the argument that, as the question here decided is doubtful, all doubts should be resolved in favor of the taxpayer. It is the function and duty of courts to resolve doubts. We know of no reason why that function should be abdicated in a tax case more than in any other where the rights of suitors turn on the construction of a statute and it is our duty to decide what that construction fairly should be. Here doubts which may arise upon a cursory examination of §§ 101 and 115 disappear when they are read, as they must be, with every other material part of the statute, *Hellmich* v. *Hellman*, supra (276 U.S. 237, 72 L. ed. 546, 48 S. Ct. 244, 56 A.L.R. 379), and in the light of their legislative history. Moreover, every deduction from gross income is

allowed as a matter of legislative grace, and 'only as there is clear provision therefor can any particular deduction be allowed . . . a taxpayer seeking a deduction must be able to point to an applicable statute and show that he comes within its terms.' *New Colonial Ice Co.* v. *Helvering*, 292 U.S. 435, 440, 78 L. ed. 1348, 1352, 54 S. Ct. 788." Id. p. 292

Deputy v. *DuPont*, 308 U.S. 488 (1940). The taxpayer claimed to deduct, as a business expense or as "interest," sums which he had paid the lenders of shares of stock as the equivalent of the dividends upon the borrowed shares, all under somewhat special circumstances. The court said

> "But allowance of deductions from gross income does not turn on general equitable considerations. It 'depends upon legislative grace; and only as there is clear provision therefor can any particular deduction be allowed.' *New Colonial Ice Co.* v. *Helvering*, 292 U.S. 435, 440, 78 L. ed 1348, 1352, 54 S. Ct. 788. And when it comes to construction of the statutory provision under which the deduction is sought, the general rule that 'popular or received import of words furnishes the general rule for the interpretation of public laws,' *Maillard* v. *Lawrence*, 16 How (U.S.) 251, 261, 14 L. ed. 925, 930, is applicable." Id. p. 493.

Helvering v. *Northwest Steel Rolling Mills*, 311 U.S. 45 (1940). The question was whether a state charter of a corporation was "a written contract executed by the corporation" preventing the payment of dividends and permitting a credit under the undistributed profits tax law. The court said that

> "It has been said many times that provisions granting tax exemptions are to be strictly construed." Id. p. 49.

(This is perhaps a little stronger language than the previous cases justified, but the court was endeavoring to make a compact statement of a principle.)

Helvering v. *Ohio Leather Co.*, 317 U.S. 102 (1942). This was another undistributed profits tax case. It was said that since the particular section in question

> "grants a special credit in the nature of a deduction, the taxpayer must sustain the burden of showing compliance with its exact terms." Id. p. 106.

Equitable Life Assurance Society v. *Commissioner*, 321 U.S. 560, 88 L. Ed. 927 (1944). In this case, certain "excess interest dividends" upon insurance policies were held not deductible. Reference was made to

> "the strict rule of construction which has obtained in case of deductions." Id. p. 605.

Yet what the court actually did in this case was to refuse to expand the meaning of "interest" to cover certain amounts which were capable of being declared or withheld at the pleasure of the Board of Directors of the insurance company — "a degree of contingency," as the court said, which the notion of interest ordinarily lacks. Id. p. 605. The word "expand" correctly describes what the court was being asked to do and its reference to the "strict rule of construction" was plainly only by way of contrast.

It will have been observed that each generalization used in the language of the above opinion has been consistent with the proper use, and only inconsistent with the improper extension, of the rule for resolving doubts in the taxpayer's favor.

We believe the whole business comes down to this: The Tax is levied upon *net income* I. R. C. §§ 13 (b); (15) (b) etc. Gross income and deduction are alike but factors in a

formula by which Congress directs the determination of "net income" for tax purposes. No aspect of a tax law should be construed, against a taxpayer, as going beyond the clearly perceptible intendment of the words actually used by Congress. On the other hand, words of exemption, deduction and the like, are not to be extended, in the taxpayer's favor, beyond their natural intendment. There is no common law of income taxation. The citizen is entitled to keep his money unless Congress has actually said he must part with it. And what Congress did say, not what it might have said (or the Commissioner wishes it had said), governs.

APPENDIX B.

Excerpts from MOODY'S MANUAL OF INVESTMENTS, 1943, American & Foreign, Railroad Securities, MOODY'S INVESTORS' SERVICE, 65 Broadway, New York, Page 450.

ERIE RAILROAD COMPANY—General Mortgage Income 4½s, due January 1, 2015

Rating—B

Open Mortgage—Series A, Limited to $54,500,000; outstanding, December 31, 1942, $51,391,215; held by or for Company, $636,710.

DATED—July 1, 1941.

MATURITY—January 1, 2015.

INTEREST—Payable annually April 1 at rate of 4½% per annum, out of available net income, only to extent earned, cumulative to extent earned up to a maximum of 13½% (excluding interest owing as a debt in a given year but paid on interest debts in succeeding year). Accumulated interest up to maximum shall be paid from available net income to extent hereinafter provided, and in any event, whether earned or not, at maturity or redemption of Series A Income Bonds.

Principal and interest payable at Company's New York office in U. S. legal tender.

INTEREST PAYMENTS—Per $1000 bond: April 1, 1942 and 1943, $45.

AVAILABLE NET INCOME—Available net income for each calendar year is after fixed charges of company and its wholly-owned railway subsidiaries on a consolidated basis, without adjustments, except that (1) deficits from

one or more calendar years shall be deducted until such deficit (or accumulated or remaining deficits) be extinguished, and (2) debits and credits to adjust income in prior years shall be treated as income items for the year in which entered on the books, whether cleared through income or profit and loss accounts, so far, but only insofar, as such debits and credits reflect cash receipts or disbursements in the year in which they are entered on the books.

Available net income for each calendar year shall be applied as follows in order shown: (1) capital expenditure fund [see under first consolidated bonds (No. 5)]; (2) an amount equal to lesser of (a) balance of such available net income not applied as above and (b) 10% of principal amount of any emergency bonds issued which shall be applied as a sinking fund payment; (3) sinking fund on first consolidated mortgage bonds; (4) interest on income bonds, also any accumulated unpaid interest (provided that such interest need be paid only in multiples of ¼%); (5) sinking fund on income bonds, series A; (6) sinking fund for income bonds of series other than series A; (7) corporate purposes, including dividends on preferred and common stocks.

The following material, drawn from the indenture itself may show rather more clearly than the above excerpt, the nature of the 13½% "cumulative" provision.

Excerpt from Erie Railroad Company 4½% Income Bond Series A, due January 1, 2015

". . . to pay interest on said sum from the date hereof until the payment of said principal sum at the rate of four and one-half per cent. (4½%) per annum, beginning April 1, 1942, on April 1 of each year thereafter, to and including April 1, 2014, and on January 1, 2015 (in each instance through the December 31 next preceding), and to pay an amount equal to

interest at such rate from January 1, 1940, to the date hereof, *but, except as otherwise provided herein or in the Indenture hereinafter mentioned, only if and to the extent that the amounts applicable thereto under the provisions of the Indenture are sufficient to make such interest payments* and until the maturity of this Bond only upon presentation and surrender of the appropriate coupons as provided in the Indenture. *Unpaid interest will accumulate*[1] *to an amount not exceeding, prior to maturity (exclusive of interest earned as provided in the Indenture but unpaid) 13½% of the principal hereof at any one time and such accumulated interest will be payable thereafter if earned as provided in the Indenture or, in any event, at the maturity of this Bond whether by declaration or otherwise.*" (Italics supplied)

Provisions of Article 5 of the mortgage indenture, too lengthy to quote herein, deal with the determination of "available net income," provide for numerous deductions therefrom for various purposes and state that "any the[illegible]remaining available net income shall be applied to the pay[illegible]f interest on the bonds." Other lengthy provisions may b[illegible]marized as providing that interest for each year shall accrue and become owing as a debt only if and to the extent that the amounts applicable to the payment thereof, under the provisions just mentioned above, shall suffice therefor. The provisions are elaborate and include other restrictions or qualifications of the obligation.

---

[1] It will be noted that only three years' unearned interest becomes unqualifiedly payable out of 74 years that the bond has to run to maturity.

APPENDIX C.

Excerpts from Statutes Showing the Liberalization of the Interest Deduction in the case of Corporations Afforded by the Revenue Act of 1918

Revenue Act 1916, Section 5

"Sec. 5. That in computing net income in the case of a citizen or resident of the United States—

(a) For the purpose of the tax there shall be allowed as deductions—

Second. All interest paid within the year on his indebtedness;"

Revenue Act 1916, Section 12 (a)

"Sec. 12. (a) In the case of a corporation, joint-stock company or association, or insurance company, organized in the United States, such net income shall be ascertained by deducting from the gross amount of its income received within the year from all sources—

Third. The amount of interest paid within the year on its indebtedness to an amount of such indebtedness not in excess of the sum of (a) the entire amount of the paid-up capital stock outstanding at the close of the year, or, if no capital stock, the entire amount of capital employed in the business at the close of the year, and (b) one-half of its interest-bearing indebtedness then outstanding: *Provided*, That for the purpose of this title preferred capital stock shall not be considered interest-bearing indebtedness, and interest or dividends paid upon this stock shall not be deductible from gross income: *Provided further*, That in cases wherein shares of capital stock are issued without par or nominal value, the amount of paid-up capital stock, within the meaning of this section, as represented by such shares,

will be the amount of cash, or its equivalent, paid or transferred to the corporation as a consideration for such shares: *Provided further*, That in the case of indebtedness wholly secured by property, collateral, tangible or intangible, the subject of sale or hypothecation in the ordinary business of such corporation, joint-stock company or association as a dealer only in the property constituting such collateral, or in loaning the funds thereby procured, the total interest paid by such corporation, company, or association within the year on any such indebtedness may be deducted as a part of its expenses of doing business, but interest on such indebtedness shall only be deductible on an amount of such indebtedness not in excess of the actual value of such property collateral: *Provided further*, That in the case of bonds or other indebtedness, which have been issued with a guaranty that the interest payable thereon shall be free from taxation, no deduction for the payment of the tax herein imposed, or any other tax paid pursuant to such guaranty, shall be allowed; and in the case of a bank, banking association, loan or trust company, interest paid within the year on deposits or on moneys received for investment and secured by interest-bearing certificates of indebtedness issued by such bank, banking association, loan or trust company;"

Revenue Act 1918, Section 234 (a)

"Sec. 234. (a) That in computing the net income of a corporation subject to the tax imposed by section 230 there shall be allowed as deductions:

(2) All interest paid or accrued within the taxable year on its indebtedness, except on indebtedness incurred or continued to purchase or carry obligations or securities (other than obligations of the United States issued after September 24, 1917) the interest upon which is wholly exempt from taxation under this title as income to the taxpayer, or, in the case of a foreign corporation, the proportion

of such interest which the amount of its gross income from sources within the United States bears to the amount of its gross income from all sources within and without the United States;"

APPENDIX D.

Specimen Definitions of the Terms Indebtedness and Interest

Indebtedness: The state of being in debt, without regard to the ability or inability of the party to pay the same . . . . But . . . there must be an actual liability . . . . to pay then or at a future time.—*Bouvier's Law Dictionary, Rawle's Third Revision, Vol. 2, p. 1531.*

"1. State of being indebted. 2. The sum owed; debts, collectively." *Webster's New International Dictionary, Second Edition, Unabridged, Vol. II, p. 1261.*

Indebted: "1. Brought into debt; being under obligation; held to payment or requital; in debt." *Webster, op. cit., Vol. II, p. 1261.*

Debt: "A sum of money due by certain and express agreement." *Bouvier, op. cit. Vol I, p. 786.*

"That which is due from one person to another . . . money . . . that which one person is bound to pay to another . . . an obligation or liability." *Webster, op. cit. Vol. I, p. 678.*

Interest: "On debts. The compensation which is paid by the borrower of money to the lender for its use, *and generally, by a debtor to his creditor in recompense for his detention of the debt.*" *Bouvier, op. cit., Vol. II, p. 1642.* (Italics ours)

"The price or rate of premiums per unit of time that is paid by a borrower for the use of what he borrows; specif. *a rate per cent of money paid for the use of money or the forbearance of demanding payment of a debt.*" *Webster, op. cit., Vol. II, p. 1294.* (Italics ours)

FILE COPY

Office - Supreme Court, U. S.
FILED
APR 21 1945
CHARLES ELMORE CROPLEY
CLERK

No. 1070

In the Supreme Court of the United States

OCTOBER TERM, 1944

TALBOT MILLS, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIRST CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

INDEX

	Page
Opinions below	1
Jurisdiction	1
Question presented	2
Statute and regulations involved	2
Statement	3
Argument	8
Conclusion	10

CITATIONS

Cases:	
Commissioner v. *O. P. P. Holding Corp.*, 76 F. 2d 11	9
Commissioner v. *H. P. Hood & Sons*, 141 F. 2d 467	9
Commissioner v. *John Kelley Co.*, 146 F. 2d 466, petition for certiorari pending, No. 948, present Term	9
Commissioner v. *Meridian & Thirteenth R. Co.*, 132 F. 2d 182	9
Deputy v. *du Pont*, 308 U. S. 488	9
Equitable Society v. *Commissioner*, 321 U. S. 560	8
Staked Plains Trust v. *Commissioner*, 143 F. 2d 421	9
Statute:	
Internal Revenue Code:	
Sec. 23 (26 U. S. C. Sec. 23)	2, 8
Sec. 115 (26 U. S. C. Sec. 115)	2
Miscellaneous:	
Treasury Regulations 103, promulgated under the Internal Revenue Code, Sec. 19.23(b)–1	3, 9

640548—45

In the Supreme Court of the United States

OCTOBER TERM, 1944

No. 1070

TALBOT MILLS, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIRST CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the Tax Court (R. 73–81) is reported in 3 T. C. 95. The opinion of the Circuit Court of Appeals (R. 93–104) is reported in 146 F. 2d 809.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on December 22, 1944 (R. 104). The petition for a writ of certiorari was filed on March 22, 1945. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

For 80 percent of its outstanding stock, taxpayer, a family corporation, substituted notes providing for maturity in 1964, interest at a variable rate of from two percent to ten percent contingent upon annual net earnings, deferment of interest in the discretion of the directors, subordination of both principal and interest to outside indebtedness, and other restrictions. The question is whether "interest" accrued by taxpayer for its fiscal year 1940 at the rate of ten percent, computed with reference to its net earnings for that year, was in reality a dividend and accordingly not deductible as interest on indebtedness within the meaning of Section 23 (b) of the Internal Revenue Code.

STATUTE AND REGULATIONS INVOLVED

Internal Revenue Code:

> SEC. 23. DEDUCTIONS FROM GROSS INCOME.
>
> In computing net income there shall be allowed as deductions:
>
> * * * * *
>
> (b) *Interest.*—All interest paid or accrued within the taxable year on indebtedness, * * *
>
> * * * * *
>
> (26 U. S. C., Sec. 23.)
>
> SEC. 115. DISTRIBUTIONS BY CORPORATIONS.
>
> (a) *Definition of Dividend.*—The term "dividend" * * * means any distribu-

tion made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year * * *.

* * * * *

(26 U. S. C. Sec. 115.)

Treasury Regulations 103, promulgated under the Internal Revenue Code:

SEC. 19.23 (b)-1. *Interest.* — Interest paid or accrued within the year on indebtedness may be deducted from gross income, * * *.

* * * * *

So-called interest on preferred stock, which is in reality a dividend thereon, cannot be deducted in computing net income. * * *

STATEMENT

The facts as stipulated (R. 8–53) and found by the Tax Court (R. 74–78) may be summarized as follows:

Taxpayer, a Massachusetts corporation, keeps its books and files its returns on the accrual method, and on the basis of fiscal years ending September 30. Prior to the beginning of its fiscal year ending September 30, 1940 (the taxable year), it had outstanding 5,000 shares of $100 par-value common stock, or total capital stock of $500,000, and a surplus on its books of $472,-

754.18. The stock was held by 15 stockholders who, with the exception of one holder of 10 qualifying shares, were either members of the Talbot family or trusts created by them. (R. 9–10, 74.)

In 1937, after taxpayer had been operating for several years at a loss, there was some discussion among the stockholders regarding liquidation. On the basis of a proposed plant renovation and personnel reorganization, and also a possible recapitalization, they decided to continue the business. In May 1939, the treasurer was authorized "to retain counsel to examine the capital structure of the company with the view to seeing if any modification can be made in same to the advantage of the company." On September 14, 1939, a plan of reorganization was submitted to and adopted by the directors and on September 29, 1939, it was approved by the stockholders. (R. 11, 40–41, 74.) The plan called for surrender by each stockholder of four-fifths of his stock in exchange for "registered notes" of face amount equal to the par value of the stock surrendered, and pursuant thereto $400,000 of notes were issued to the stockholders in exchange for a like amount of stock (R. 11–12, 74).

The notes provide for maturity on December 1, 1964, and for interest at a variable annual rate dependent upon taxpayer's annual net earnings. The interest rate is to range from two percent to ten percent, the applicable rate for any fiscal year to

correspond to the percentage (to the nearest ¼ percent) which two-thirds of taxpayer's net earnings for the year bears to the principal amount of the notes. The interest so determined is payable on December 1 of each year, but payment of it may be deferred for any length of time (not beyond the maturity date of the notes) that the board of directors "may in good faith determine to be necessary by reason of the condition of the corporation." No dividends are to be paid on the remaining one-fifth of the stock until interest due on the notes is satisfied. (R. 19–20, 74–75.)

In the event of bankruptcy, receivership, dissolution or liquidation prior to December 1, 1964, the principal, together with interest accrued and unpaid, is to become immediately due, with interest at six percent from the close of the preceding fiscal year. However, the directors are authorized "to subordinate all of these notes as to both principal and interest to any other indebtedness of the corporation maturing not later than December 1, 1964," in which event any sums or other property payable on the notes are to be paid over to creditors to whose claims the notes have been subordinated. The corporation may at any time retire the notes at par plus accrued interest, unless otherwise provided in any subordination agreement. No mortgage to secure an obligation maturing after December 1, 1964, other than a purchase money mortgage, may be made without

the consent of holders of three-fifths in interest of the notes. (R. 21–22, 75–76.)

Any of the terms of the notes may be altered by the corporation with the consent of holders of three-fifths in interest; provided that no such change shall extend the maturity date for the principal or reduce the principal amount, alter the rate or method of computing the rate of interest, or affect any subordination agreement in force (R. 23–24, 76).

The notes are transferable by endorsement on an attached form. Only a few notes, totalling $6,800, have been transferred, all within the close family circle. (R. 24, 76.)

Tax avoidance was a motivating factor in the adoption of the plan (R. 74), and appears to have been the only substantial purpose underlying the exchange of notes for stock (R. 80).

Within two weeks after the adoption of the plan, and on October 10, 1939, the notes were subordinated by taxpayer's directors to two loans from one bank in the amounts of $50,000 and $30,000, respectively, bearing interest at four percent and three percent per annum, respectively; to a $50,000 loan from another bank, bearing interest at four percent per annum; and to a $100,000 loan from another creditor, bearing interest at six percent. The subordination agreement with the two banks covered all existing and future indebtedness and provided that so long as any part

of the bank indebtedness remained unsatisfied taxpayer would not pay and the noteholders would not accept any payment of principal or interest on the notes; that in case of taxpayer's bankruptcy or any other liquidation proceeding the noteholders would assign and pay over to the banks all distributions to which they might be entitled in such proceedings; and that in case of a reorganization or composition any payment to the noteholders would likewise be turned over to the banks. All these subordinations have since been terminated by payment of the senior obligations. (R. 14, 29–35, 76–78.)

Shortly after the close of the taxable year, and on November 27, 1940, taxpayer's treasurer reported that (R. 13, 78):

> * * * he had ascertained and fixed at 10 per cent the rate of interest applicable to the registered notes of this corporation for and on account of the fiscal year ended September 28, 1940, such rate of 10 per cent being a rate less than that computable with reference to the net earnings of said fiscal year under the terms of said notes and being the maximum rate provided by the terms of said notes.

This report was forthwith accepted and approved. The directors then voted to defer payment of three-fourths of this interest, which amounted to $40,000 and would otherwise be payable December 1, 1940. The $40,000 was paid in

three installments, as follows: $10,000 on December 2, 1940, $10,000 on March 27, 1941, and $20,000 on September 15, 1941. (R. 9–10, 14, 78.)

In its return for the fiscal year ending September 30, 1940, taxpayer deducted the $40,000 as interest accrued for that year. The Commissioner disallowed the deduction on the ground that it did not represent interest within the meaning of Section 23 (b) of the Internal Revenue Code, resulting in deficiencies in taxpayer's income and declared value excess profits tax in the amounts of $6,940.15 and $2,415.73, respectively. (R. 10, 59, 73.) The Tax Court sustained the Commissioner's determination (R. 85), and the Circuit Court of Appeals affirmed (R. 104).

ARGUMENT

There is no occasion for further review. The decision below is in harmony with decisions of this Court and no conflict among the circuits exists.

1. "Interest * * * on indebtedness" within the meaning of Section 23 (b) of the Internal Revenue Code, *supra*, p. 2, does not embrace amounts payable upon a contingency. *Equitable Society* v. *Commissioner*, 321 U. S. 560. The fundamental difference between deductible interest and a non-deductible dividend is that the former is payable absolutely, irrespective of whether the taxpayer has earnings, while the latter is dependent upon earnings. The cases ac-

cordingly uniformly hold that whether so-called interest is "in reality" a dividend (Section 19.23 (b)-1 of Treasury Regulations 103, *supra*, p. 3), turns primarily upon this distinguishing feature. See *Commissioner* v. *John Kelley Co.*, 146 F. 2d 466 (C. C. A. 7th), petition for certiorari pending, No. 948, present Term; *Commissioner* v. *Meridian & Thirteenth R. Co.*, 132 F. 2d 182, 185 (C. C. A. 7th); *Commissioner* v. *H. P. Hood & Sons*, 141 F. 2d 467 (C. C. A. 1st). The courts below correctly held that the deduction here claimed did not qualify as "interest" because taxpayer did not contract to pay a fixed rate irrespective of earnings, but a variable rate contingent upon the amount of its annual net earnings.[1]

2. The decision below is clearly in accord with *Commissioner* v. *O. P. P. Holding Corp.*, 76 F. 2d 11 (C. C. A. 2d), upon which taxpayer relies as creating a conflict (Pet. 4, 12–13). The court there stressed the very criterion which the court below emphasized. It pointed out (76 F. 2d at

[1] Nor did the claimed deduction constitute interest on "indebtedness," since it did not represent an amount which taxpayer contracted to pay "for the use of borrowed money." *Deputy* v. *du Pont*, 308 U. S. 488, 497–498. The so-called notes which taxpayer substituted for a portion of its outstanding capital stock were merely new evidences of risk capital. Cf. *Staked Plains Trust* v. *Commissioner*, 143 F. 2d 421 (C. C. A. 5th). Moreover, as the court below noted (R. 99–100), the "notes" bore many of the characteristics of preferred stock.

p. 12) that the taxpayer was obligated to pay a fixed rate of interest "regardless" of whether it had earnings, that "This distinction marks the vital difference between the shareholder and the creditor," and that the numerous decisions in this field "may be harmonized by adopting the criterion above suggested." Taxpayer's assertion (Pet. 5, 23–27) that the instant case presents an important issue rests on the assumption that the controlling principles are unsettled. While each case necessarily turns on its own facts, the applicable legal standards are established and there is no conflict among the circuits.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

CHARLES FAHY,
Solicitor General.
SAMUEL O. CLARK, JR.,
Assistant Attorney General.
SEWALL KEY,
J. LOUIS MONARCH,
HARRY BAUM,
Special Assistants to the Attorney General.

APRIL 1945.

U. S. GOVERNMENT PRINTING OFFICE: 1945

FILE COPY

Office - Supreme Court, U. S.
FILED
OCT 8 1945
CHARLES ELMORE CROPLEY
CLERK

No. 47

In the Supreme Court of the United States

OCTOBER TERM, 1945

TALBOT MILLS, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIRST CIRCUIT

BRIEF FOR THE RESPONDENT

INDEX

	Page
Opinions below	1
Jurisdiction	1
Question presented	2
Statute and regulations involved	2
Statement	3
Summary of argument	10
Argument:	
I. The court below properly affirmed the holding of the Tax Court since, viewing the transaction from any standpoint, it constitutes an issue of preferred stock	16
A. The provisions of the "registered notes" are frequent and authorized clauses familiar to preferred stock, and the circumstances surrounding their issue and their treatment since issue further confirm their character as stock	18
B. Whether the question presented is considered to turn on its special facts or whether it is considered to be a question of law, turning on the meaning of "indebtedness" as used in the statute, the court below and the Tax Court properly looked to the actualities of the situation in determining whether the corporate distributions were dividends or interest on indebtedness	28
II. The contract does not as a matter of law require the payment of interest	35
Conclusion	39

CITATIONS

Cases:	
Adams v. *Commissioner*, 5 T. C. No. 40	31
Bakers' Mutual Coop. Ass'n v. *Commissioner*, 117 F. 2d 27	20
Brown-Rogers-Dixon Co. v. *Commissioner*, 122 F. 2d 347	31
Cass v. *Realty Securities Co.*, 148 App. Div. 96, affirmed, 206 N. Y. 649	26
Choate v. *Commissioner*, 324 U. S. 1	35
Collier, Matter of, 112 Misc. 70	26
Commissioner v. *Court Holding Co.*, 324 U. S. 331	34
Commissioner v. *Drovers Journal Pub. Co.*, 135 F. 2d 276	36
Commissioner v. *H. P. Hood & Sons*, 141 F. 2d 467	31, 32
Commissioner v. *Meridian & Thirteenth R. Co.*, 132 F. 2d 182	22, 26, 27
Commissioner v. *O. P. P. Holding Corp.*, 76 F. 2d 11	31

Cases—Continued	Page
Commissioner v. *Proctor Shop*, 82 F. 2d 792	30, 34
Commissioner v. *Schmoll Fils Associated*, 110 F. 2d 611	25, 27, 38
Crimmins & Pierce v. *Kidder, Peabody Ac. Corp.*, 282 Mass. 367	26
Cring v. *Sheller Wood Rim Mfg. Co.*, 98 Ind. App. 310	26
Deputy v. *duPont*, 308 U. S. 488	36
Dobson v. *Commissioner*, 320 U. S. 489, rehearing denied, 321 U. S. 231	32
Equitable Society v. *Commissioner*, 321 U. S. 560	37, 38
Fidelity Savings & Loan Ass'n v. *Burnet*, 65 F. 2d 477	27
Finance & Investment Corp. v. *Burnet*, 57 F. 2d 444	26
1432 Broadway Corporation v. *Commissioner*, 4 T. C. 1158	31
Gregory v. *Helvering*, 293 U. S. 465	34
Griffiths v. *Commissioner*, 308 U. S. 355	34
Hamlin v. *Toledo, St. L. & K. R. Co.*, 78 Fed. 664	22
Helvering v. *Clifford*, 309 U. S. 331	34
Helvering v. *Morgans, Inc.*, 293 U. S. 121	18
Helvering v. *Stockholms &c. Bank*, 293 U. S. 84	18
Higgins v. *Smith*, 308 U. S. 473	34
Huisking & Co. v. *Commissioner*, 4[illegible] C. 595	31
Jones, Arthur R., Syndicate v. *Commi[illegible]er*, 23 F. 2d 833	31
Kelley, John, Co. v. *Commissioner*, 140 F. 2d 466, No. 36, this Term	17, 31
Kentucky River Coal Corp. v. *Lucas*, 51 F. 2d 586, affirmed, 63 F. 2d 1007	26
Old Colony R. Co. v. *Commissioner*, 284 U. S. 552	36
Pacific Southwest R. Co. v. *Commissioner*, 128 F. 2d 815, certiorari denied, 317 U. S. 663	26
Petit Anse Co. v. *Commissioner*, decided October 27, 1944	31
Spies v. *Chicago & E. I. R. Co.*, 40 Fed 34	23, 39
Staked Plains Trust v. *Commissioner*, 143 F. 2d 421	30, 32
Thomas v. *N. Y. & G. L. R. Co.*, 139 N. Y. 163	24
Union Pacific R. R. Co. v. *United States*, 99 U. S. 402	24
Whitridge v. *Mt. Vernon Woodberry Cotton Duck Co.*, 210 Fed. 302	24
Wiggin Terminals, Inc. v. *United States*, 36 F. 2d 893	31
Statutes:	
Internal Revenue Code:	
Sec. 23 (26 U. S. C. 1940 ed., Sec. 23)	2, 10
Sec. 115 (26 U. S. C. 1940 ed., Sec. 115)	2
Sec. 719 (26 U. S. C. 1940 ed., Sec. 719)	33
Miscellaneous:	
1 Cook, Corporations (8th Ed.) Sec. 273	20
6 Fletcher, Cyclopedia Corporations (Perm. Ed.), Sec. 2645	24
12 Fletcher, Cyclopedia Corporations (Perm. Ed.), Sec. 5447	20
Treasury Regulations 103, Sec. 19.23 (b)–1	3
Treasury Regulations 109, Sec. 30.719–1	32, 34
Treasury Regulations 112, Sec. 35.719–1	33

In the Supreme Court of the United States

OCTOBER TERM, 1945

No. 47

TALBOT MILLS, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIRST CIRCUIT

BRIEF FOR THE RESPONDENT

OPINIONS BELOW

The opinion of the Tax Court (R. 73–81) is reported in 3 T. C. 95. The opinion of the Circuit Court of Appeals (R. 93–100) and the dissenting opinion (R. 100–104) are reported in 146 F. 2d 809.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on December 22, 1944. (R. 104.) The petition for writ of certiorari was filed March 22, 1945, and was granted April 30, 1945. (R. 104.) The jurisdiction of this Court is invoked

under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether taxpayer corporation was entitled to deduct, as "interest" on "indebtedness" within the meaning of Section 23 (b) of the Internal Revenue Code, payments made during the taxable year to holders of its so-called "registered notes".

STATUTE AND REGULATIONS INVOLVED

Internal Revenue Code:

> SEC. 23. DEDUCTIONS FROM GROSS INCOME.
> In computing net income there shall be allowed as deductions:
>
> * * * * * *
>
> (b) *Interest.*—All interest paid or accrued within the taxable year on indebtedness, except on indebtedness incurred or continued to purchase or carry obligations (other than obligations of the United States issued after September 24, 1917, and originally subscribed for by the taxpayer) the interest upon which is wholly exempt from the taxes imposed by this chapter. [26 U. S. C. 1940 ed., Sec. 23.]
>
> * * * * * *
>
> SEC. 115. DISTRIBUTIONS BY CORPORATIONS.
> (a) *Definition of Dividend.*—The term "dividend" when used in this chapter (except in section 203 (a) (3) and section

207 (c) (1), relating to insurance companies) means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made. [26 U. S. C. 1940 ed., Sec. 115.]

* * * * * *

Treasury Regulations 103, promulgated under the Internal Revenue Code:

SEC. 19.23 (b)–1. *Interest.*—Interest paid or accrued within the year on indebtedness may be deducted from gross income, * * *

* * * * * *

So-called interest on preferred stock, which is in reality a dividend thereon, cannot be deducted in computing net income. * * *

STATEMENT

Most of the facts were stipulated; others not stipulated were found by the Tax Court from the record made at the hearing before it. (R. 74.)

Taxpayer is a Massachusetts corporation, with principal offices at North Billerica, Massachusetts, engaged in the manufacture of woven woolen and

worsted fabrics. (R. 55, 94.) Taxpayer keeps its books and files its returns on the accrual basis (R. 10); the taxable year involved is the fiscal year ending September 30, 1940. (R. 73.) Prior to the beginning of this fiscal year and prior to any of the transactions out of which the present controversy arose, taxpayer had outstanding as its total capital stock five thousand shares of common stock, par value $100. (R. 74.) This stock was held on September 30, 1939, by 15 stockholders who, with the exception of one holder of ten shares to qualify as a director, were all members of the Talbot family by descent or marriage, or were trusts created by such members. (R. 10, 74.)[1]

For several years prior to 1937 the company had been gradually losing money and in 1937 there was discussion among the stockholders as to liquidation. However, upon the basis of a proposed renovation of plant and changes in personnel, plus possible recapitalization, they decided to continue the business. On May 8, 1939, the treasurer was authorized by corporate resolution "to retain counsel to examine the capital structure of the company with the view to seeing if any modification can be made in same to the advantage of the company." (R. 74.) On September 14, 1939, a plan of reorganization was submitted to

[1] All of the stockholders were descendants from three brothers or were married to a descendant of the three brothers. Two of these brothers had founded the business. (R. 62.)

and adopted by the directors and on September 29, 1939, it was approved unanimously by the stockholders. (R. 74.) Pursuant to this plan, each stockholder surrendered four-fifths of his stock which was duly retired by the corporation, and the capital stock accordingly reduced. In return for the stock surrendered taxpayer issued "registered notes", in aggregate face value equal to the aggregate par value of the stock retired. Thus the total amount of the notes issued was $400,000. (R. 74.)

The notes are stated to mature December 1, 1964, slightly more than 25 years from the date of issue. (R. 74–75).[2] They provide for annual interest payable on December 1 of each year, but payment of interest may be deferred by vote of the board of directors for such time as they (R. 75)—

> * * * may in good faith determine to be necessary by reason of the condition of the corporation * * * provided that such suspension of payment shall in no wise relieve the corporation of the obligation to pay the amount suspended at some future time and shall in no event operate to defer payment beyond December 1, 1964.

[2] The notes are dated October 2, 1939, but due to delay in printing the notes were not actually signed and delivered to the proper recipients before November 14, 1939. Subject, however, only to this delay in actual delivery they were outstanding in the aggregate sum of $400,000 during taxpayer's entire taxable year. (R. 12.)

They provide for interest at an annual rate ranging from a minimum of two percent to a maximum of ten percent, dependent upon the taxpayer's annual earnings. (R. 75.)[3] The notes

[3] The provisions of the notes in full with respect to interest are as follows (R. 20):

> Interest hereon shall be payable annually on December 1 of each year for and on account of the fiscal year of the corporation ended last previous to such December 1, the first such date for the payment of interest being December 1, 1940, at a rate which shall not exceed 10 per cent nor be less than 2 per cent and, subject to these limitations, shall be a rate computed as follows:— There shall be taken a sum equal to two-thirds (2/3ds) of the net earnings of the corporation for the fiscal year ended last previous to such December 1, computed in accordance with the regular bookkeeping methods and practices of the corporation as established from time to time in good faith by its directors and officers but without deduction for federal income taxes paid or accrued and without deduction for interest upon these notes, and the rate of interest shall be the rate, figured to the nearest one-quarter per cent (¼%) which such sums would represent as interest upon an assumed principal sum of Four Hundred Thousand ($400,000) Dollars. Provided, nevertheless, that from and after the close of the fiscal year ended next previous to December 1, 1964, and for such further time as this note shall remain unpaid, interest shall be at the rate of six percent (6%) per annum, and such interest to December 1, 1964, shall be included in the installment payable at that date.
>
> The corporation shall have the power, by vote of its Board of Directors, to defer the payment of all or part of any annual installment of interest for such time as the directors may in good faith determine to be necessary by reason of the condition of the corporation, without incurring liability for interest upon such deferred installment of interest, provided that such suspension of payment shall in no wise relieve the corporation of

further provide that no dividends are to be paid on any shares of stock until all then due interest upon the notes, including postponed interest, shall have been paid in full. In the event of bankruptcy, receivership, dissolution or liquidation, principal and interest are to become immediately due, with interest at the rate of six percent from the close of the preceding fiscal year. (R. 75.)

While no mortgage of taxpayer's real estate or of its machinery or equipment, to secure an obligation after December 1, 1964, other than a purchase money mortgage, can be made while the notes are outstanding, without the consent of the holders of three-fifths in interest of the notes, nevertheless, the directors are authorized to subordinate both principal and interest to any indebtedness of the corporation maturing not later than December 1, 1964. (R. 75–76.) The corporation may at any time pay and retire the notes at par, plus accrued interest, except as otherwise provided in any subordination agreement. The notes also provide (R. 76):

> * * * With the written consent of the corporation and of the holders of three-fifths (3/5ths) in amount of the total

---

the obligation to pay the amount suspended at some future time and shall in no event operate to defer payment beyond December 1, 1964. The corporation covenants that it will pay no dividends upon any shares of stock of the corporation unless and until all then due interest upon these notes, including interest which may have been postponed as aforesaid, shall have been paid in full.

amount of these notes at the time outstanding, filed with the corporation, any of the terms and provisions of this series of notes may be altered or amended so as to bind the corporation and every holder, whether consenting or not, provided that no such change shall:—(a) extend the date for the maturity of the principal of the notes; (b) alter the rate of interest or the method of computing the rate of interest, except in so far as required for an adjustment to a changed fiscal year as above; (c) diminish the principal amount payable at maturity or the amount to be paid upon any earlier payment as above provided; or (d) vacate or diminish the effect of any subordination previously voted and in force.

The Tax Court further found that (R. 80):

> The factor of tax avoidance loomed large in the minds of the parties by their own admission, and indeed appears to have been the only substantial purpose motivating the transaction. * * * Each shareholder retained the precise voice in the management which he had prior to the transaction. He retained the same right to participate in the profits of the business; what he did not receive by way of interest he would take by way of dividends on his remaining stock. * * *

Shortly after the plan had gone into effect the "registered notes" on October 10, 1939, by vote of taxpayer's board of directors, were subordi-

nated to two bank loans aggregating $100,000 and a formal subordination agreement was executed. On the same date the notes were also subordinated to a $100,000 machinery loan and to a further $30,000 indebtedness to one of the banks. (R. 76–78.) The subordinations were as to both principal and interest, and those to the banks covered all existing and future indebtedness. (R. 77.) All of the subordinations have since been terminated by payment of the obligations. (R. 78.)

The notes are transferable by endorsement on an attached form, which is required to be authenticated by the clerk of the corporation. (R. 76.) In the year following issue some few totaling $6,800 were transferred, but always within the close family circle. (R. 76.)

On November 27, 1940, taxpayer's treasurer reported that (R. 78):

> * * * he had ascertained and fixed at 10 percent the rate of interest applicable to the registered notes of this Corporation for and on account of the fiscal year ended September 28, 1940, such rate of 10 percent being a rate less than that computable with reference to the net earnings of said fiscal year under the terms of said notes and being the maximum rate provided by the terms of said notes.

The report was forthwith accepted and approved. The directors then voted to defer the

payment of three-fourths of the interest which would otherwise be payable on December 1, 1940. On March 25, 1941, this deferment was partially terminated, and on September 15, 1941, wholly terminated, so that in three installments over the course of the fiscal year the total of $40,000 was disbursed.[4] It is the deduction of this amount which the Commissioner contests.[5] (R. 78.) The Tax Court sustained the Commissioner (R. 85) and the court below (one judge dissenting) affirmed the Tax Court (R. 104).

SUMMARY OF ARGUMENT

I

Section 23 (b) allows a deduction for "interest" paid on an "indebtedness." But the legislative history and the regulations make it clear that corporate distributions, however labeled, are not to be deducted as interest where they are essentially dividends.

A. Viewed from any standpoint the instant transaction constitutes an issue of preferred stock. The provisions of the "registered notes" are frequent clauses familiar to preferred stock and the circumstances surrounding their issue and their

---

[4] The amount of $40,000 was paid as follows: $10,000 on December 2, 1940; $10,000 on March 27, 1941; $20,000 on September 15, 1941. (R. 9–10.)

[5] The tax deficiencies in controversy are $6,940.15 in income tax and $2,415.73 in declared value excess profits tax. (R. 73, 85.)

treatment since issue further confirm their character as stock. The name borne by the security is of little importance. The substantial legal rights and duties which the instrument creates, read in the light of the surrounding circumstances, are the determining factor, and the misuse of words cannot change the legal conclusions which follow from these rights and obligations.

The income feature bears a close resemblance to capital stock. The interes rate is variable, ranging from a minimum of 2% to a maximum of 10%, dependent upon taxpayer's net earnings. Moreover, at the election of taxpayer, interest payments may be deferred until December 1, 1964, and in conjunction with the written consent of holders of three-fifths in amount of notes at the time outstanding, taxpayer may amend the terms of every note so as to defer interest payment for a further and indefinite period. The payments above 2% are, like dividends, limited to a distribution of net corporate earnings during a given year and are not cumulative. Each of the 15 shareholders retains the same proportionate right to participate in the profits which he had possessed prior to the transaction, and what each shareholder does not receive by way of interest on his "note", he takes by way of dividends on his stock. Again, as in the case of dividends, the distribution is essentially dependent upon th directors' discretion, and the instant agreement, as security for the payment of interest, is actually no more than

the pledge of the good faith of the company in managing its business. Similarly, as with dividends, the exercise of the directors' discretion, as to what part of the earnings shall be used for alterations, repairs, other expenses, payment of current obligations, depreciation, and other reserves, and what balance remains as net income for distribution to holders of these securities, is unlimited in the absence of bad faith, and a mistake of judgment will afford no ground of complaint. Essentially, a noteholder here, like a stockholder, is merely an adventurer in the corporate business; he profits only from its success, and lacking such success, he contracts for and is entitled to no fixed return upon his money whatsoever. The long continued Treasury Regulations, denying a deduction of "so-called interest on preferred stock, which is in reality a dividend thereon", are here clearly applicable.

Moreover it is immaterial that the instruments on their face do not authorize the noteholders to participate in the management of their business. Such is commonly the case with preferred stockholders. Indeed, here the Tax Court found that the noteholders, a small family group, are identical with the stockholders and are actually the managers of the business, and were, through the directorate elected by them during the taxable year, the persons who determined what portion of the net earnings should be dis-

tributed in the guise of interest and what portion paid candidly as dividends.

Furthermore, the right to repayment of principal investment at a definite time is a proper and not uncommon provision of preferred stock, always subject as here, to the rights of creditors. Thus, taxpayer has unlimited authority to subordinate all of the notes as to both principal and interest to any other existing or future indebtedness maturing not later than December 1, 1964. Hence, these noteholders are no true creditors, but like other proprietors of a business, assume the risk of its every undertaking. Since payment of interest, even as to the minimum of 2%, may be deferred at the "debtor's" option for approximately twenty-five years without incurring liability for interest, there is no real provision for default of nonpayment of interest. Since "maturity" date is fixed twenty-five years in the future, the factor of default upon nonpayment of principal is likewise minimized, and since the agreement enables the debtor to subordinate the noteholders' claims to the rights of all other creditors, the purported maturity becomes comparatively meaningless. Except in taxation, there is no practical difference between preferred stock with or without maturity date and these notes with so-called maturity date.

B. Whether the question presented is considered to turn on its special facts or whether it is considered to be a question of law turning on the

meaning of "indebtedness" as used in the statute, the court below and the Tax Court properly looked to the actualities of the situation in determining whether the corporate distributions were dividends or interest on indebtedness. The Tax Court found that tax avoidance appears to have been the only substantial purpose for the transaction, and what the parties really intended to create was a security retaining the profit-sharing advantage of stock, leaving intact their voice in the management, but extending a tax advantage to the corporation not possible in stock. The Tax Court further found that the notes had no business purpose and their issuance brought no new capital into the corporation, but represented a mere exchange which did not in any material way affect the previously existing situation. The court below is clearly sustained by authority in holding that the Tax Court was entitled to consider these circumstances in making its findings.

In any event, if the question here presented is deemed to turn on its special facts, the Tax Court was correct in holding that the payments made were not deductible as interest on indebtedness, and the record amply sustains its finding. On the other hand, if the question whether the contract obligated the payment of "indebtedness" turns on the meaning of that word as used in the statute and is held to be a question of law, the Commissioner contends that these subordinable notes,

bearing variable and deferable interest depending on earnings, do not as a matter of law constitute indebtedness within the meaning of the statute. Moreover, the Tax Court and the court below correctly determined that the circumstances under which the contract was made and the instruments were issued did not involve the payment of genuine interest on a genuine indebtedness. Upon such an issue, namely, the essential nature of a transaction, the finding of the Tax Court, as here, when warranted by the record, is entitled to finality.

II

Finally, the contract does not as a matter of law require the payment of interest. Congress has allowed a deduction only of "interest" and proof that the payment is an "interest" payment remains the primary prescription of the statute. It is not enough for a taxpayer to establish that the indebtedness exists and that a sum, which is not interest, has been paid in connection with or in consideration for the indebtedness; the burden is affirmatively upon him to establish that he has paid strictly "interest". Hence, even assuming *arguendo* that these notes represent an "indebtedness", payments of this uncertain, indefinite and discretionary character geared to corporate earnings cannot as a matter of law constitute "inter-

est" within the meaning of the statute. Certainly, this is true so far as payments in excess of 2% are concerned, and indeed the 2% minimum stands upon no better footing, for not only does it form an integral part of the whole arrangement but payment of the minimum in the case of any noteholder may be deferred indefinitely beyond December 1, 1964, upon the joint election of taxpayer and the holders of three-fifths in amount of notes then outstanding. These so-called interest payments, which are contingent (a) upon the existence of gross earnings; (b) upon their existence during a given calendar year; and (c) upon the exercise of managerial discretion of directors, substantially as broad as that which exists in the case of dividends on stock, have a degree of uncertainty which the notion of interest ordinarily lacks. Certainly they do not satisfy a strict rule of construction, and Congress intended strictly "interest" to be deducted and nothing else.

ARGUMENT

I

THE COURT BELOW PROPERLY AFFIRMED THE HOLDING OF THE TAX COURT SINCE, VIEWING THE TRANSACTION FROM ANY STANDPOINT, IT CONSTITUTES AN ISSUE OF PREFERRED STOCK

The pertinent Treasury regulations and the legislative history of Section 23 (b) of the Internal Revenue Code, allowing a deduction for

"interest" paid on "indebtedness", are considered in the Government's brief in *John Kelley Co.* v. *Commissioner*, No. 36, where it is shown that under the strict rule of construction applicable to such deductions, no allowance is to be given for corporate distributions that are in reality dividends to stockholders. (Pp. 22–27.) It is immaterial that the payments be labeled "interest" on an "indebtedness", and the circumstances of this case, discussed below, amply support the conclusion that the payments out of income on the "registered notes" herein are not deductible as interest on a debt.

The decisions in this field refute the claim made here that all interest upon all indebtedness is deductible. This contention ignores the fact that the words of the statute upon which taxpayer relies are only a part of the Revenue Act and do not fully disclose the purpose of Congress. Therefore, in applying this statute the courts have been influenced by the fact that it is the Congressional policy to distinguish between dividends and interest; that Congress has permitted a deduction for the payment of interest on indebtedness but has withheld a deduction for the payment of dividends to stockholders. Thus the question here is not merely whether any of the rights secured to the holders of these notes is foreign to an indebtedness. Rather, the question is whether any of the rights conclusively earmarks the notes as evidences of indebtedness and distinguishes them from stock certificates.

For the reasons hereinafter stated, we believe there is no single right or combination of rights accorded by these notes which can be said to distinguish the holders from stockholders. Accordingly, the Tax Court was bound to inquire into the circumstances under which these notes were issued.

Taxpayer's assumption (Br. 35–38) that the failure to classify these notes as indebtedness under Section 23 (b) would result in difficulties in applying other sections of the Code is erroneous. If it becomes necessary to classify similar notes under other sections of the Code where the same Congressional policy is not involved, the result might well be different. Cf. *Helvering* v. *Stockholms &c. Bank*, 293 U. S. 84, 87. Taxpayer's argument exhibits the same basic fallacy throughout. It attempts to isolate and construe literally a single provision of the Code. This was disapproved in *Helvering* v. *Morgans, Inc.*, 293 U. S. 121, 126, where it was pointed out that the true meaning of a single section of a complex Revenue Act, however precise its language, cannot be ascertained by considering it apart from other sections of the statute and its legislative history.

A. THE PROVISIONS OF THE "REGISTERED NOTES" ARE FREQUENT AND AUTHORIZED CLAUSES FAMILIAR TO PREFERRED STOCK, AND THE CIRCUMSTANCES SURROUNDING THEIR ISSUE AND THEIR TREATMENT SINCE ISSUE FURTHER CONFIRM THEIR CHARACTER AS STOCK

The income features bear a close resemblance to capital stock. The interest rate is variable,

ranging from a minimum of 2% to a maximum of 10%, dependent upon taxpayer's net earnings. Nominally interest is payable annually on December 1st of each year on account of the fiscal year of the corporation ended last previous (September 30th). The rate is computed as follows, subject to the minimum and maximum limitation (R. 20):

> There shall be taken a sum equal to two-thirds (⅔ds) of the net earnings of the corporation for the fiscal year ended last previous to such December 1, computed in accordance with the regular bookkeeping methods and practices of the corporation as established from time to time in good faith by its directors and officers but without deduction for federal income taxes paid or accrued and without deduction for interest upon these notes, and the rate of interest shall be the rate, figured to the nearest one-quarter per cent (¼%) which such sums would represent as interest upon an assumed principal sum of Four Hundred Thousand ($400,000) Dollars.

Moreover, taxpayer has the power, by vote of its board of directors, to defer the payment of all or part of any annual instalment of interest for such time as the directors may in good faith determine to be necessary by reason of the condition of the corporation, without incurring liability for interest upon a deferred instalment of interest. (R. 20.) By this provision taxpayer has the power to defer an interest payment on its

own motion to December 1, 1964 (R. 20); moreover, in conjunction with the written consent of the holders of three-fifths in amount of notes at the time outstanding, taxpayer may amend the terms of the notes so as to bind every holder and thus defer the payment of interest for a further and indefinite period (R. 23–24).

The payment of so-called "interest" is not merely dependent upon there being earnings, i. e., gross earnings, but upon there being profit, i. e., "net earnings." The payments above 2% accordingly, are limited exclusively to a distribution of the corporate earnings or profits during a given year. Characteristically such distributions are dividends. As the court said, in *Bakers' Mutual Coop. Ass'n* v. *Commissioner*, 117 F. 2d 27, 28 (C. C. A. 3d):

> The taxpayer argues that even if there was not an unconditional obligation to pay interest on the certificates, certainly there was an obligation to pay the interest if there were profits. But such a distribution of corporate earnings comes within the definition of a dividend in the Revenue Act 1932, § 115, 26 U. S. C. A. Int. Rev. Acts, page 520, and therefore this argument is unavailing.

Further, the payments do not even possess the assurance of preferred dividends,* but like com-

* Preferred dividends, unless express provision is made to the contrary, are cumulative. 1 Cook, Corporations (8th Ed.), Sec. 273; 12 Fletcher, Cyclopedia Corporations (Perm. Ed.), Sec. 5447.

mon stock, dividends (except for the 2% minimum) are not cumulative.

It is apparent, as the court below and the Tax Court respectively pointed out, that each of the 15 shareholders retained the same proportionate right to participate in the profits of the business which he had possessed prior to the transaction, and what each stockholder did not receive by way of interest on his "note" he took by way of dividends on his stock. (R. 80, 97.) On the notes, as on the stock, the noteholder assumes substantially the risks of a proprietor. He is merely an adventurer in the corporate business; he profits only from its success, and lacking such success, he contracts for and is entitled to no return (with the exception of the deferable 2%) upon his money, whatsoever.

The taxpayer in the present case has not contracted to pay a fixed rate of interest regardless of whether or not its net earnings are sufficient. Not only is payment deferable but the rate itself is variable depending upon earnings and is determined only after conclusion of the fiscal year. The rate is not fixed in advance, and until fixed is contingent. Thus, it cannot be said that the noteholder has a right to his interest in any event, since he can not know until after the end of the fiscal year what the rate will be, and the notes authorize the directors to suspend the payment of interest even after the rate has been determined when the needs of the business require such action. Indeed, here taxpayer actually deferred

payment of three-quarters of the deduction claimed as interest nominally due December, 1940, and did not make full payment until September 15, 1941. (R. 9–10.) Moreover, no provision is made for interest to be paid on suspended payments and they are subjected to the risks of the enterprise. Interest is a certain payment whose amount is known in advance; dividends are uncertain in amount and there is no absolute right to them. *Commissioner* v. *Meridian & Thirteenth R. Co.,* 132 F. 2d 182, 187 (C. C. A. 7th). In holding that similar provisions constituted dividends, not interest, the Circuit Court of Appeals for the Sixth Circuit in *Hamlin* v. *Toledo, St. L. & K. R. Co.,* 78 Fed. 664, said (pp. 669–670):

> That these shares are declared to carry "interest at the rate of four per cent. per annum, payable semi-annually, represented by coupons attached," is not conclusive that they are debt obligations. By calling a dividend "interest," the essential nature of the thing is not changed. We must look deeper. When we do so, we find that this "interest" is to be paid only out of "the net earnings" after paying interest upon the first mortgage bonds, "and the cost of maintenance and operation." We further find that this so-called "interest" is "non-cumulative." The net earnings of each year are to be ascertained. If there are none, after paying interest on the first mortgage bonds and operating expenses and expenses of maintenance, no "interest" is to to be paid; and when, at any time, such a

happy state of affairs is found to exist as a surplus, so that anything can be paid upon the current year's "interest," all past due coupons for "unearned interest" are to be surrendered. Thus, this "interest" has all the characteristics of a preference, in dividends to the extent of four per cent. per annum, over the common stock, and none of the marks of interest proper.

Furthermore, as in the case of dividends, the distribution is essentially dependent upon the directors' discretion, which, if exercised in good faith, the noteholder cannot control. As said in *Spies* v. *Chicago & E. I. R. Co.*, 40 Fed. 34, 38 (C. C. S. D. N. Y.):

> *An income railway mortgage, * * * is, as a security for the payment of interest, but little more than the pledge of the good faith of the company in managing its lines.* It necessarily contemplates that such improvements as seem necessary to the efficient use and operation of such property, and such alterations in the *corpus* as appear desirable, are to be made, at the discretion of the directors; and unless it contains some limitations upon the powers of the directors, express or implied, the right of the company to conduct its operations as it may see fit, subject only to the conditions of its organic law, is unqualified; and consequently the company can lawfully extend its lines, acquire new ones, discontinue old ones, and thus essentially change the earning capacity of the property. [Italics supplied.]

There are here no contractual restrictions on the power of the directors. Such income payments are further subject to the directors' discretion to retain portions of gross income as reserves against depreciation. *Whitridge* v. *Mt. Vernon Woodberry Cotton Duck Co.*, 210 Fed. 302 310 (Md.).

As in the case of dividends, the exercise of the directors' discretion, as to what part of the earnings shall be used for alterations, repairs, other expenses, payment of current obligations, depreciation and other reserves, and what balance remains as *net* income for distribution to holders of these securities, is unlimited in the absence of bad faith. A mistake in judgment as to the necessity or extent of expenditures will afford no ground of complaint by the security holders. The power of control by the directors, as compared to that existing in the case of stockholders, is substantially unimpaired, and as a practical matter, it is left to them to ascertain whether any of the company's earnings shall be paid to these certificate holders. *Union Pacific R. R. Co.* v. *United States*, 99 U. S. 402, 404, 420–423; *Thomas* v. *N. Y. & G. L. R. Co.*, 139 N. Y. 163, 183–184; 6 Fletcher, *supra*, Sec. 2645. Thus, irrespective of whether "income bonds" may in some instances be considered "indebtedness," we contend that the noncumulative provisions of the instant securities, combined with their other features, establish them to be stock, rather than bonds.

It is immaterial that the instruments on their face do not authorize the noteholder to participate in the management of the business. Such is commonly the case with preferred stockholders. *Commissioner* v. *Schmoll Fils Associated,* 110 F. 2d 611, 613 (C. C. A. 2d). Indeed, here the facts which the Tax Court found establish that the noteholders, a small family group, are identical with the stockholders and are actually the managers of the business. Each shareholder retained the precise voice in the management which he had prior to the transaction. (R. 80.) The stockholders retained the same proportionate control of the corporation as owners. (R. 97.) "A very slight fraction" of the notes were negotiated, but remained in the "close family circle". (R. 89.) During the taxable year in question the uncontroverted fact is that the noteholders were the managers of this business and were, through the directorate elected by them, the persons who determined what portion of the net earnings should be distributed in the guise of interest and what portion paid candidly as dividends.

Besides, the provision that taxpayer (R. 20)—

> will pay no dividends upon any shares of stock of the corporation unless and until all then due interest upon these notes, including interest which may have been postponed as aforesaid, shall have been paid in full

a common protection afforded preferred stock-

holders, further establishes the character of these instruments as stock, not debt.[7]

Furthermore, a right to payment at a definite time is recognized as a proper and not uncommon provision of preferred stock, always subject, by implied or as here by express agreement, to the rights of all creditors. The security remains, nevertheless, stock, not indebtedness. *Kentucky River Coal Corp.* v. *Lucas*, 51 F. 2d 586 (W. D. Ky.), affirmed, 63 F. 2d 1007 (C. C. A. 6th); *Finance & Investment Corp.* v. *Burnet*, 57 F. 2d 444, 445 (App. D. C.); *Pacific Southwest R. Co.* v. *Commissioner*, 128 F. 2d 815 (C. C. A. 9th), certiorari denied, 317 U. S. 663; *Commissioner* v. *Meridian & Thirteenth R. Co.*, *supra*; *Cring* v. *Sheller Wood Rim Mfg. Co.*, 98 Ind. App. 316, 320; *Crimmins & Peirce* v. *Kidder, Peabody Ac. Corp.* 282 Mass. 367, 374–376. The noteholders are here substantially in the position of such preferred stockholders. Thus, taxpayer has authority, by vote of its board of directors, to subordinate all of these notes as to both principal and interest to any other indebtedness of the corporation maturing not later than December 1, 1964, existing at or after the time of such vote. (R. 21.) Indeed, taxpayer exercised this power during the taxable year in question and subordi-

[7] An income "bond" was held preferred stock within the meaning of the New York inheritance tax statute in *Matter of Collier*, 112 Misc. 70, 72–74 (N. Y.), following *Cass* v. *Realty Securities Co.*, 148 App. Div. 96, 100–101 (N. Y.), affirmed, 206 N. Y. 649.

rated the $400,000 of so-called "notes" to $230,000 of debts. (R. 76–78.) In *Fidelity Savings & Loan Ass'n* v. *Burnet*, 65 F. 2d 477 (App. D. C.), where the right of withdrawal existed at any time—not postponed to a date approximately twenty-five years hence—the Court of Appeals of the District of Columbia held the certificate to represent stock, not indebtedness. There also, income was payable out of earnings (p. 480), while the shareholder (p. 481)—

> had, it is true, the advantages of withdrawal which the holder of permanent stock did not have, but this advantage accrued only during the solvency of the corporation.

Commissioner v. *Schmoll Fils Associated, supra; Commissioner* v. *Meridian & Thirteenth R. Co., supra,* pp. 186–187. It follows inescapably that these "noteholders" are no true creditors, but like the other proprietors of the business, assume the risks of its every undertaking.

Moreover, since payment of interest, even as to the minimum 2%, may be deferred at the "debtor's" option for approximately 25 years without incurring liability for interest, there is no real provision for default in payment of interest. Since the maturity date is fixed 25 years in the future, the factor of default upon nonpayment of principal is presently negligible. Besides, since the agreement enables the debtor to subordinate these particular creditors' rights (even 25 years hence) to the rights of all other creditors secured

or unsecured, the purported "maturity" becomes comparatively meaningless.[8] Except in taxation, there is no practical difference between preferred stock with or without maturity date and these notes with so-called maturity date.

B. WHETHER THE QUESTION PRESENTED IS CONSIDERED TO TURN ON ITS SPECIAL FACTS OR WHETHER IT IS CONSIDERED TO BE A QUESTION OF LAW, TURNING ON THE MEANING OF "INDEBTEDNESS" AS USED IN THE STATUTE, THE COURT BELOW AND THE TAX COURT PROPERLY LOOKED TO THE ACTUALITIES OF THE SITUATION IN DETERMINING WHETHER THE CORPORATE DISTRIBUTIONS WERE DIVIDENDS OR INTEREST ON INDEBTEDNESS

The Tax Court found (R. 80-81):

> The factor of tax avoidance loomed large in the minds of the parties by their own admission, and indeed appears to have been the only substantial purpose motivating the transaction. * * *
>
> * * * what the parties really intended to create was a security retaining the profit-sharing advantage of stock, leaving intact their voice in the management, but extending a tax advantage to the corporation not possible in stock.

---

[8] The notes are not even afforded protection against the mortgage of fixed assets so long as the obligation secured matures prior to December 1, 1964, and with the consent of three-fifths of the outstanding noteholders the fixed assets may be mortgaged to secure an obligation maturing subsequent to December 1, 1964. This is less security than, by way of covenant against future encumbrance, is often afforded preferred stock. (R. 21.)

Taxpayer has throughout asserted that the notes offered two business advantages to the corporation, first, through reduction in equity control, enabling a concentration of control to effect a stable management, and second, a more negotiable and hence more readily salable security. However, the Tax Court found both these assertions unconvincing (R. 80.) As to the first, it found since each shareholder retained the precise voice in the management which he had prior to the transaction, a pro rata reduction of capital could not facilitate concentrated control, and as a matter of fact did not change the control in the business or in the distribution of its profits. On the contrary, the arrangement was calculated to assure each shareholder that what he did not receive by way of interest, he would take anyhow by way of dividends on his stock. (R. 80.) Thus, taxpayer was able to procure unsecured bank loans at an interest rate of 4% (R. 14); indeed, the notes had to be subordinated to these loans "in order to induce the Banks not to demand payment" (R. 30). At the November 27, 1940, directors' meeting fixing the rate of interest for the taxable year at 10% and deferring payment of three-fourths of it, "the Treasurer reported the ability to pay all bank loans and the arrangement to borrow $400,000 at 3%." (R. 48–49.) As to the second asserted advantage, the Tax Court questioned the additional salability of the "restricted, subordinated, deferable notes" over the original stock.

(R. 80.) In fact, the few notes negotiated ($6,800 out of $400,000), remained within the close family circle. (R. 76.) A finding that these restricted securities issued by this corporation, which throughout its history has constituted the property of a small family unit, are not genuinely marketable or more readily salable than the pre-existing stock, surely finds ample support in the evidence.

The issuance of the notes brought no new capital into the corporation. There was a mere exchange which did not in any material way affect the previously existing interest of the stockholders. The subordinable notes, paying a variable and deferable return dependent upon earnings, were, like stock, geared to the fortunes of the enterprise. Expectation of any return on the investment and the time of payment were dependent upon the prosperity and the convenience of the corporation. The rights and indeed, the identity, of these so-called creditors were assimilated to those of the stockholders. This is not a case where securities originated in borrowing or where they are in the hands of persons distinct from the stockholders. The court below was clearly correct in holding that the Tax Court was entitled to consider these circumstances and all the actualities of the situation. *Commissioner* v. *Proctor Shop*, 82 F. 2d 792, 794 (C. C. A. 9th). To the same effect are *Staked Plains Trust* v. *Commissioner*, 143 F. 2d 421 (C. C. A. 5th); *John*

Kelley Co. v. *Commissioner*, 146 F. 2d 466 (C. C. A. 7th);[9] *Brown-Rogers-Dixon Co.* v. *Commissioner*, 122 F. 2d 347, 350 (C. C. A. 4); *Huisking & Co.* v. *Commissioner*, 4 T. C. 595, 600;[10] *1432 Broadway Corporation* v. *Commissioner*, 4 T. C. 1158; *Adams* v. *Commissioner*; 5 T. C. No. 40;[11] *Petit Anse Co.* v. *Commissioner*, decided October 27, 1944 (1944 P-H T. C. Memorandum Decisions, par. 44,370).[12] Compare *Arthur R. Jones Syndicate* v. *Commissioner*, 23 F. 2d 833 (C. C. A. 7th); *Wiggin Terminals, Inc.* v. *United States*, 36 F. 2d 893 (C. C. A. 1st). But cf. *Commissioner* v. *O. P. P. Holding Corp.*, 76 F. 2d 11 (C. C. A. 2d); *Commissioner* v. *H. P. Hood & Sons*, 141 F. 2d 467 (C. C. A. 1st).

In *John Kelley Co.* v. *Commissioner, supra*, to be argued immediately before the instant case, the transaction closely resembles that involved in the case at bar. There so-called interest also was geared to earnings and depended upon the good faith and managerial discretion of taxpayer's directors. The instruments were also subject to claims of all creditors. Taxpayer was a family corporation and exchange of stock for the alleged

[9] No. 36, this term, to be argued immediately before the instant case.

[10] Taxpayer's appeal pending in the Second Circuit Court of Appeals.

[11] Taxpayer's appeal pending in the Second Circuit Court of Appeals.

[12] Taxpayer's appeal pending in the Fifth Circuit Court of Appeals.

debentures did not affect in any substantial way the previously existing interest for the stockholders. There the method which the Tax Court had expressly employed in testing its fact findings established that its conclusion was arbitrary and amply justified reversal by the Circuit Court of Appeals. The record in the cited case was destitute of evidence to support the finding which the Tax Court had made, and the taxpayer having the burden, the reviewing court properly reversed the order of the Tax Court. The "debentures" there could not as a matter of law constitute indebtedness. Besides, as here, the uncertain, indefinite, and discretionary character of the so-called interest payments limited to corporate earnings could not as a matter of law constitute "interest" within the meaning of the statute. See Point II, *infra*.

In any event, if the question here presented is deemed to turn on its special facts, the Tax Court was correct in holding that the payments made were not deductible as "interest" on "indebtedness", and the record amply sustains its findings. *Dobson* v. *Commissioner*, 320 U. S. 489, rehearing denied, 321 U. S. 231; *Commissioner* v. *H. P. Hood & Sons, supra*, p. 471; *Staked Plains Trust* v. *Commissioner, supra*, p. 422.[13] On the other

[13] Compare Treasury Regulations 109, relating to the Excess Profits Tax under the Internal Revenue Code as amended by the Second Revenue Act of 1940, applicable to the taxable years beginning after December 31, 1939; i. e., to

hand, if the question whether the contract obligated the payment of "indebtedness" turns on the meaning of that word as used in the statute and is therefore to be treated as a question of law, the Commissioner contends that (1) these subordinable notes, bearing variable and deferable interest depending on earnings, do not as a matter of law constitute "indebtedness" within the meaning of the statute; and (2) the Tax Court and the court below correctly determined that the circumstances under which the contract was made and the instruments were issued did not involve

---

taxable years subsequent to those here involved, reading as follows (Sec. 30.719–1):

> Whether outstanding certificates designated by such names as "debenture preferred stock" or "guaranteed preferred stock" constitute borrowed capital depends upon whether the holder has a proprietary interest in the corporation or has the rights of a creditor, determined in the light of all the facts. The name borne by the certificate is of little importance. More important attributes to be considered are whether or not there is a maturity date, the source of payment of any "interest" or "dividend" specified in the certificate (whether only out of earnings or out of capital and earnings), rights to enforce payment, and other rights as compared with those of general creditors.

Section 35.719–1 (d) of Treasury Regulations 112, likewise relating to the Excess Profits Tax under the Internal Revenue Code as amended for taxable years beginning after December 31, 1941, is identical. Section 719 of the Internal Revenue Code, to which this regulation refers, provides for the inclusion in invested capital for excess profits tax purposes of 50% of borrowed capital. The regulation thus follows the court decisions, which have interpreted the interest deduction.

the payment of genuine interest on a genuine indebtedness.[14]

What the law recognizes is an actual, not a merely formal borrowing. *Commissioner* v. *Proctor Shop, supra;* cf. *Gregory* v. *Helvering,* 293 U. S. 465; *Griffiths* v. *Commissioner,* 308 U. S. 355; *Higgins* v. *Smith,* 308 U. S. 473; *Helvering* v. *Clifford,* 309 U. S. 331. As this Court has recently held in *Commissioner* v. *Court Holding Co.,* 324 U. S. 331, 334:

> The incidence of taxation depends upon the substance of a transaction. The tax consequences which arise from gains from a sale of property are not finally to be determined solely by the means employed to transfer legal title. Rather, the transaction must be viewed as a whole, and each step, from the commencement of negotiations to the consummation of the sale, is relevant. * * * To permit the true nature of a transaction to be disguised by mere formalisms, which exist solely to alter tax liabilities, would seriously impair the effective administration of the tax policies of Congress.

---

[14] Compare Treasury Regulations 109, relating to the Excess Profits Tax, *supra,* fn. 13, reading as follows (Sec. 30.719–1):

> In order for any indebtedness to be included in borrowed capital it must be bona fide. It must be one incurred for business reasons and not merely to increase the excess profits credit.

The Tax Court, referring to "circumstances surrounding the issuance, to determine the intent of the parties" (R. 80), found that "no proper indebtedness" (R. 81) was created. That finding is entitled to finality on appeal (cf. *Choate* v. *Commissioner*, 324 U. S. 1, 3–4) and brings into play the rule of the *Gregory* and *Griffiths* cases, *supra*, that the Court will look to the essential nature of a transaction, disregarding any steps or legalistic devices having no business purpose other than tax avoidance.

II

THE CONTRACT DOES NOT AS A MATTER OF LAW REQUIRE THE PAYMENT OF INTEREST

Congress has allowed a deduction only of "interest" and proof that a payment is an "interest" payment remains the primary prescription of the statute; it is not enough for taxpayer to establish that an "indebtedness" exists and that a sum, which is not "interest", has been paid in connection with or in consideration for the indebtedness; the burden is affirmatively upon him to establish that he has paid strictly "interest". Hence, even assuming, *arguendo*, that these notes represent an indebtedness, payments of this uncertain, indefinite, and discretionary character, geared to corporate earnings, cannot as a matter of law constitute "interest" within the meaning of the statute. Certainly, this is true so far as any payments in excess of 2% are concerned; and indeed, the 2%

minimum stands upon no better footing, for not only does it form an integral part of the whole arrangement, but, as already noted, payment of the minimum in the case of any noteholder may be deferred indefinitely beyond December 1, 1964, upon the joint election of taxpayer and the holders of three-fifths in amount of notes then outstanding. (R. 23.)

This Court has held that "interest" is used in this statute in its "usual, ordinary and everyday meaning" (*Old Colony R. Co.* v. *Commissioner*, 284 U. S. 552, 561), and that (p. 560) "the usual import of the term is the amount which one has contracted to pay for the use of borrowed money." Again, in *Deputy* v. *du Pont*, 308 U. S. 488, this Court said (p. 498): "We are dealing with the context of a revenue act and words which have today a well-known meaning." Thus, all carrying charges are not interest (*Deputy* v. *du Pont, supra*, p. 497), nor amounts ascribed to a time period prior to the date the loan was made (*Commissioner* v. *Drovers Journal Pub. Co.*, 135 F. 2d 276 (C. C. A. 7th), although the contract for the use of the money includes a binding promise to pay them. Such agreements do not fall within the ordinary meaning of the term in the context of the statute.

In the context of the Internal Revenue Code and of the long-standing Regulations construing it, so-called "interest", which is in reality a dividend, cannot be deducted. The deduction which

Congress intended was not a contingent, discretionary distribution of earnings and profits, but a fixed and definite charge, known in advance, collectible absolutely, as a debt against the taxpayer's entire assets, in the nature of a cost of the business.

This Court has recently held in *Equitable Society* v. *Commissioner*, 321 U. S. 560, 564, that—

> payments made wholly at the discretion of the company have a degree of contingency which the notion of "interest" ordinarily lacks

even though there (p. 564) "the obligation to pay the principal amount * * * was absolute", and the so-called "interest" was not conditioned on the existence of surplus or earnings. In the instant case the analogy to dividends is more perfect in the respect that 80% of the "interest" payments can be made only out of earnings. In fact, the source is even more limited than is commonly true in the case of dividends, for here the payment may not be made out of surplus or earnings of past years, but is restricted to "the net earnings of the corporation for the fiscal year ended last previous to such December 1". (R. 20.)

Moreover, as also already discussed, the directors' discretion is substantially as broad and untrammeled as that accorded in the case of dividend declarations; in practice, the only dis-

tinction is a formal one. In both cases the amount to be distributed is a balance remaining after the directors have exercised their unlimited judgment in the use of the gross corporate earnings for expenses, repairs, current obligations, and reserves; in the case of the dividend, a formal declaration is necessary, but this, particularly where the stock is preferred, may not arbitrarily be denied. As the Second Circuit Court of Appeals said, referring to similar income provisions (though there cumulative), in *Schmoll Fils Associated, supra* (p. 613):

> Almost the only difference between the debenture holders and holders of cumulative preferred stock is that the former may require payment of their interest out of any net earning of the company, whereas preferred stockholders are able to compel payment of a dividend only in case the directors arbitrarily refuse to declare it.

These so-called interest payments are thus here to a large extent contingent (a) upon the existence of gross earnings; (b) upon their existence during a given calendar year (uncertainties additional to those present in *Equitable Society* v. *Commissioner*, 321 U. S. 560); and (c) upon the exercise of managerial discretion by directors substantially as broad as that which exists in the case of dividends on stock, to permit to remain unexpended a balance of net earnings. They are completely contingent upon the exercise of managerial discretion by directors, similar to that

which exists in the case of dividends on stock, to defer payment for the maximum of twenty-five years, and in conjunction with three-fifths of the noteholders, to defer payment for a longer and indefinite period. Certainly, the instant agreement does not satisfy a strict rule of construction; and Congress intended strictly "interest" to be deducted and nothing else. A deferable obligation, limited largely to distribution of earnings of a given year, which amounts to "but little more than the pledge of the good faith of the company in managing" its business (*Spies* v. *Chicago & E. I. R. Co.*, *supra*, p. 38), does not conform to the businessman's notion of interest, nor fall within the purview of the statute.

CONCLUSION

The decision of the Circuit Court of Appeals is correct and should be affirmed.

Respectfully submitted.

HAROLD JUDSON,
Acting Solicitor General.
SAMUEL O. CLARK, JR.
Assistant Attorney General.
J. LOUIS MONARCH,
MARYHELEN WIGLE,
I. HENRY KUTZ,
Special Assistants to the Attorney General.

OCTOBER 1945.

U. S. GOVERNMENT PRINTING OFFICE: 1945